Revised Model Business Corporation Act= RMBCA

DE= Delaware

MA- Model Act

Business Organizations Outline

1. Introduction/Definitions:

* Business organization- one or more persons who work together for a common business purpose and who share in the risks and rewards of their efforts.
  + The text says two or more persons
  + The law of business organizations is about the men and women who own in, and invest in, and manage businesses of all sizes.
* Business Structures:
  + Opting into an entity’s default rules reduces transactional costs
  + The goal of the business structure is to lower costs (agency costs)
  + When organizations are formed, agents are hired.
  + Businesses should form the entity that reduces agency costs- some theorists argue this.
* Types of Organizations:
  + Corporations
  + Partnerships
  + LLCs
  + Limited Partnerships
  + Limited Liability Partnerships
  + Private Companies- stock is not traded publicly traded and cannot be purchased in the marketplace
  + Public Companies- the stock is available in the marketplace
  + Benefit Corporations (newly emerged)- hybrid entity of a for-profit entity and a non-profit entity
  + Non-profit entities- do not have shareholder and do not have a profit/purpose goal
* Business Lawyering: What is it?
  + Business lawyering is a cooperative enterprise
  + Business lawyers challenge and eliminate ambiguity.
  + Business lawyering is about communicating the complex to the simple
  + Business lawyers must have a prospective viewpoint- goal is to build for the future
    - Litigators view transactions retrospectively
    - Business lawyering is not adversarial
* The Great Decession- 2008-2009
* The American Business Landscape:
  + Large corporations have as much power as some nation-states.
  + Most US companies are small.
    - Smaller companies employ the most workers.
  + The American business demographic has changed in two ways in the past twenty years:

1. The predominance of manufacturing jobs has yieled to service oriented businesses.
2. The role of women and minorities have changed.
3. Participants in the Business Organization:

* Owner- has a residual or equity interest.
  + Owner exerts control over the entity.
* Lender- has a fixed claim and may try to limit the owner’s control.

1. Major Considerations when selecting the business organization:

* Formation and operation
* Who will manage
* who will make decisions
* liability
* financing
* How will investors receive a return
* Tax consequences

1. Agency: The Foundation of Partnership and Corporate Law
2. Definition and Basic Principles:

* The law of agency is a body of law built through the common law.
  + Restatement is used as a guide.
* One party acting on behalf of another
* Agent- the person acting
* Principal- the person being acted for
  + The principal is responsible for actions of the agent within the scope of the agency.
  + Focus on the scope of the agency.
* There is an implied fiduciary relationship in every agency relationship.
* Restatement Definition:
  + Agency is the fiduciary relationship that arises when one person ( a principal) manifests assent to another person (an agent) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.
* Statutes and laws do not eliminate the common law doctrine of agency

1. Agency and the Fiduciary Duty of Loyalty:

* RULE: Duty of Loyalty
  + The agent must act loyally for the principal’s benefit in all matters connected with the agency.
  + The agent assumes a fiduciary duty to act loyally for the principal’s benefit in all matters connected with the agency
  + In the absence of an agreement to the contrary, agents owned a duty of undivided loyalty to their principals.
    - Policy Rationale- This reduces agency costs.
* The duty of loyalty is the default rule.
  + Contracts can vary the default rule.
* To waive the duty of loyalty- there must be an express provision
* All profits made by the agent in the course of the agency belong to the principal.
  + Even if principal has been made whole by the wrongdoer, the principal may still recover profits from the agent.
    - Principal can also recover the amount of damage caused.
* The agent must place the principal’s interest first for matters connected with the agency relationship.
  + The agent will not be liable for a breach of the duty of loyalty if the principal consents to the act in question.
* The agent has the duty to act carefully using the “care, competence, and diligence normally exercised by agents in similar circumstances.”
* All profits of the enterprise belong to the principal.
* Principal must:
  + Provide agent with relevant facts
  + Must not comingle principal’s money or property with anyone else’s
  + Must indemnify the agent for losses incurred in connection with the agency relationship
* Agent’s Duties:
  + Duty of care, competence, and diligeence
  + Duty not to acqiure material benefits arising from agency
  + Duty not to act on behalf of adverse party
  + Duty not to compete
  + Duty not to use principal’s property
  + Duty not to use confidential information
  + Duty of good conduct
  + Duty to provide information
* Duties or Principal to Agent: These duties are contractual.
  + Act in accordance with express and implied contractual terms
  + Deal fairly with agent
  + Furnish information to the agent
  + Refrain from harming agent’s business reputation
  + Indemnify agent for losses incurred in connection with agency- MOST IMPORTANT
* Breaches in:
  + Tort
  + Contract
  + Trust- Most severe remedies available

1. Agency: The Three Components:
2. “Manifestation of consent” by the principal that the agent act for the principal;
3. Subject to the principal’s “control;”
4. Agent “manifests consent;”

* A written agreement is not required. The only requirement is a manifestation of assent.

1. How is the agency relationship formed?
2. Manifestation of consent by principal that act will act for him/her
3. Agent Accepts
4. Understanding by the parties that the principal will control the undertaking

* TOM- Control is the magic element of the agency relationship. If the plaintiff can find control by one party over another, an agency relationship may be found.
  + When the creditor assumes control, the lender may be liable.
  + If a franchise agreement allocates control to the parent corporation, an agency relationship may exist.
* A lender can become liable as principal when lender assumes control or assumes more control over the debtor.

1. The Usual Agency Relationship:

* The usual agency relationship is when a business employs a person to act for the business.

1. Characteristics and Consequences of Agency:

* The principal may not be liable for the agent’s intentional torts.
* Special Relationships:
  + Employer-employee
  + Non-employee agents (independent contractors)
    - Principals are not responsible for the torts of an independent contractor unless the principal has direct control over the contractor’s actions.
      * Exception- If the independent contractor is involved in an inherently dangerous activity.
  + Partially disclosed and undisclosed principals

1. Agency Costs:

* The goal of the business organization is to reduce or eliminate agency costs
* Shirking- the agent becoming lazy and not performing for the owner.

1. Torts of an Agent:

* For Exam:
  + Is there an employer-employee relationship? If so:
    - Did the tort occur within the scope of employment?
    - Was the action intended to serve the employer?
      * Minority position- Was the action of the employee reasonably foreseeable?
  + If no employer-employee relationship:
    - Was there control?
    - Was there an inherently dangerous activity, non-delegable duty, negligent hiring?
  + Was there apparent authority?
* Agents are personally liable for their torts.
* Principals may be liable for their agent’s torts.
* Depends on actual and apparent authority:
  + Focus on whether the tort was committed within the scope of the agency.
* Was the tortious behavior action ratified

1. Authority of an Agent:

* A principal is liable for the authorized acts of an agent.

1. Actual Authority:
2. Restatement Definition: R.3d, Section 2.01

* An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal’s manifestations to the agent, that the principal wishes the agent so to act.
* This is the authority that the agent actually knows it can perform.
* Actual authority is created by the principal’s manifestations to the agent.
* The agent must have a reasonable belief that there is authority.
* Express authority:
  + refers to authority created by the principal’s oral or written communications to the agent concerning the scope of the agent’s authority.

1. Implied/Incidental/Inherent Authority
2. Restatement Definition: R.3d., Section 2.02

* It is natural to assume that the principal wishes, as an incidental matter that the agent take the steps necessary and that the agent proceed in the usual and ordinary way.
* Implied authority can arise when the agent takes its usual steps and proceeds in a usual and ordinary way.
* Custom can create implied authority.
* Course of dealing can establish implied authority.
* Implied Authority:
  + Refers to the scope of the agent’s authority as determined by the principal’s conduct or other related circumstances.
* Incidental Authority:
  + Commonly means the agent has the authority to do whatever is required and appropriate in the usual course of business to accomplish th agent’s responsibilities.

1. Apparent Authority
2. Definition/Concept:

* Apparent authority is created only by the principal representing to third parties that they may rely on the agent.
  + Retention of an attorney is not sufficient. Nor is the authority to settle up to a certain dollar amount.
* The principal must communicate something to a third party that tells the third-party the principal is bound by the agent’s acts.
* Apparent authority is created by the principal’s manifestaions to a third party.
* As a general rule, if an agency relationship exists and the agent’s acts were authorized by the principal, third parties who have dealt with the agent may hold the principal liable.

1. Estoppel
2. Concept/Definition:

* Estoppel is a court created doctrine.
  + Estoppel is applied to few cases.
* Unique circumstances where principal’s dereliction was so egregious that principal should be estopped from denying an agency.
* Used when the agent’s acts were unauthorized by the principal, but a third-party believed the agent to be authorized, and (1) principal somehow caused this belief, or (2) principal did not take reasonable steps to inform third-parties of the facts.
* Estoppel may be created by the impression of an agency that principal could have easily negated but didn’t and a third-party relied.

1. Ratification
2. Concept/Definition:

* Even though the principal is not liable or responsible, the principal can adopt, or “ratify” the action of an agent or other party.
* Ratification is the affirmance by a person of a prior act which does not bind him but which was done or professedly done on his account, whereby the act, as to some or all persons, is given effect as it originally authorized by him.
* The principal must have all knowledge of all material facts about the act being ratified.

1. Termination of the Agency:

* Agency relationships last as long as consent lasts.
* The relationship terminates upon:
  + The death or loss of capacity by either party
  + Terminates on bankruptcy of agent or principal
* Apparent authority must also be terminated.
* Agency can terminate on consent

1. Agency Cases:
2. A. Gay jenson Farms v. Cargill, Inc
3. Facts: Farms brought an action against against Cargill and Warren to recover losses when Warren defaulted on contracts. Farms alleged Cargill was jointly and severally liable because it had acted as a principal in making the contracts.
4. Rule: A creditor who assumes control of his debtor’s business may become liable as principal for the acts of the debtor in connection with the business.
5. Holding: Although Warren and Cargill never established a formal (written agency relationship), through their course of dealing, Warren was Cargill’s agent and liable for the transactions entered into.
6. Koval & Koval v. Simon Telelect, Inc. (concerns attorney’s authority to settle a claim)
7. Facts: An attorney settled a claim in ADR. The client, who had not participated in the ADR opposed the attorney’s authority to settle the claim.
8. Rule: A client’s retention of an attorney does no in itself confer implied or apparent authority on that attorney to settle or compromise the client’s claim. The retention does confer the inherent power on the attorney to bind the client to an in-court proceeding.
9. Holding: See rule above.
10. Fennell v. TLB Kent Co. (Apparent Authority)
11. Facts: Court dismissed Fennell’s action for wrongful discharged and approved the settlement agreement negotiated without Fennell’s consent by his attorney finding that Fennell’s attorney had apparent authority to settle the case and Fennell was bound by the agreement.
12. Rule: In order to create apparent authority, the principal must manifest to the third party that he consents to have the act done on his behalf by the person purporting to act for him.
13. Holding/Analysis: A client does not create apparent authority for his attorney to settle the case merely by retaining an attorney.
14. Daynard v. Ness (Ratification case):
15. Facts: A law professor sought damages after an alleged breach of oral contract and claimed a court could have personal jurisdiction over him.
16. Rule: Where an agent acts without actual or apparent authority, the alleged principal may ratify the agent’s acts through conduct that indicates consent.
17. Holding: Defendant firm ratified second firm’s offer through conduct (accepting services). Second firm was acting with apparent authority when the offer was extended
18. Papa John’s Intrnational, Inc. v. McCoy (torts of an agent)
19. Facts: McCoy brought an action against PJ for malicious prosecution and defemation contending that a PJ franchisee made vicious statements about McCoy and PJ was vicariously liable.
20. Rule: An employer cannot be held vicariously liable for the intentional torts of its employee where the employee’s alleged tortious acts occur within an indpendent course of conduct not intended in any way to serve the employer’s purpose.
21. Holding: For an employee’s torts, focus on the motive or purpose. When the employee acts with a personal purpose, the employee is said to have departed from the scope of the agency.
22. Huong Que Inc. v. Luu (Duty of Loyalty Case)
23. Facts: Defendants sold corporation but remained managing agents and may have breached their duty of loyalty my misappropriating the customer list and soliciting customers for their own business.
24. Rule: The contractual requirement not to compete “as an owner” does not vitiate an agent’s or employee’s duty to act loyallly.
25. Holding: The duty of loyalty rises from a fiduciary relationship and does not arise from the law of contracts
26. Tarnowski v. Resop (Duty of Loyalty and Profits)
27. Facts: Tarnowski contended that his agent (Resop), while acting as an agent, collected a secret commission for consummating a sale and made fraudulent representations.
28. Rule: Fidelity in an agent is what is aimed at, and as a means of securing it, the law will not permit him to place himself in a position in which he may be tempted by his own private interests to disregard those of the principal.
29. Holding: It is not material that no injury to the principal resulted.
30. Sole Proprietorship:
31. Defintion and Background Information:

* DEFINITION:
  + A sole proprietorship is a business owned directly by one person who has sole decision making authority, an exclusive claim to business profits, and direct ownership of all business assets.
* The sole proprietorship is the most popular business organization in the United States- particularly for start-up ventures.
* No corporate code applies
  + No legal formalities.
* There are millions of soloe propietorships
* Sole proprietorships are not separate legal entities.
* Owners must file a fictitious business name (DBA)
* The owner is personally liable for all of the business’s obligations.
* Sole proprietorships are not separate from the individual owner.

1. Advantages:

* Sole proprietorships are easy to form
  + This is why there are so many of them.
* The owner owns all profits and assets.

1. Disadvantages:

* Sole proprietorships have unlimited liability
  + This increases as more employees are hired.
* Sole propietorships cannot admit new investors
* Owner is liable for all tort claims.
* The owner’s assets are exposed when the business is liable.
* Sole proprietorships are only suitable for small business with few employees.

1. Partnerships: For Exam only UPA (1997)
2. Fiduciary Relationships:

* The concept of a partnership is one firm operated by a few members having close personal relationships.
* Partnerships are based on fiduciary duties.
* Partners are agents of the partnership
* Other fiduciary relationships:
  + Corporate directors are fiduciaries to the corporation and the shareholders.
  + Corporate officers are agent and fiduciaries of the corporation.

1. Basic Principles and Definitions:

* UPA- Section 6
  + A partnership is an association of two or more persons to carry on as co-owners of a business for profit
* UPA (1997)- Section 2.02
  + ...of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.
* Partners must have a right to manage and control the entire business.
* Few partners
* Close personal relationships
  + RUPA is also UPA
* Partners can contribute either services or capital.

1. Overview of UPA and UPA (1997)

* In most cases, the case would be resolved the same under either the RUPA or UPA.
* The aplicable state law is the state where the partnership is formed.
* Concept of a few owers with close personal relationships.
* Partner unanimity required for important partnerships decisions
  + Otherwise majority of partners control
* Any partner can bind the partnership
* Default statutory provisions apply in absence of an agreement
* Partner relations are largely contractual- some provisions can be modified
* The law of agency applies to partner relations with one another and the partnerships.
* UPA (1997) introduced the LLP
* Default Rules:
  + State partnership laws apply.
  + Default rules fill any and all gaps in the partnership agreement.
  + Most rules are modifiable by agreement, but some are not: Examples of rules not modifiable
    - Unreasonable restriction to books and records
    - Cannot eliminate duty of loyalty
    - Cannot unreasonably reduce duty of care

1. Partnerships: Formation, Characteristics, Advatages and Disadvantages:

* Joint ventures are similar to partnerships
  + Joint ventures are usually in connection with bsuiness organized to complete a specific project rather than an on-going enterprise.
* Partnerships are easy to organize
* Partnerships are easy to form.
* Partnerships are inexpensive and easy to operate
* Partnerships are fragile- departure of one partner terminates the partnership
* One level of taxation
  + Each partner pays a tax on his or her share of the partnership’s profits or takes a deduction for the partnership’s share of the losses.
  + Allows for “pass-through” taxation

1. Advantages:

* One level of taxation
  + The partnership entity is not taxed. The profits are taxed at the individual level.

1. Disadvantage:

* Partners are personally liable for partnership debts.
* Any partner can bind the partnership to an obligation.

1. Formation: Similar to agency

* Partnerships can be formed by an express agreement.
* Partnerships can be formed by operation of law.
  + Individuals can default into a partnership
* CA- Agreements to share profits is not necessary in CA as evidence of formation.
  + Required in some states (TX)
* To admit a new partner, all partners must agree

1. Partnership Operations:
2. Financing:

* Partnerships are usually financed through loans or capital contributions
* There are no shares.
* Difficulties of financing the partnership:
  + Loans
  + Capital Contributions

1. Partnership Management:

* All partners have the right to manage the business.
* Voting on partnership matters is per partner.
  + Voting is not per dollar of invested capital and not per share (because there are no shares)
* Default rule- all partners have the right to manage the business within reason.
* Voting on partnership matters is per person- not per dollar of invested capital
* Partnership acts provide a default set of rles to determine who has a right to vote, how votes are allocated, and what vote is required.
* Partnership law requires unanimous approval for the admission of a new partner.

1. Taxing the Partnership:

* Partnership income is taxed at a single level.
* Partnerships have only one level of taxation.
* Partners are not taxed at the entity level- only at the individual (partner) level
* Partnerships can elect to be taxed like a corporation

1. Partnership Duties:
2. Duty of Loyalty:

* A partner owes a fiduciary duty- duty of loyalty- to the partnership.
* TOM- Put notes on states on class four slides if we are in a bind.
* Partners have the duty of utmost loyalty. Partners must look after one another as they would want to be looked after.
* CA UPA (1997) is inclusive with regard to the duty of loyalty
  + Actual UPA limits the duty of loyalty to enumerated provisions.

1. Waiving Duties:

* It is possible to waive and limit duties by agreement.
  + Can waive specific instances of duties but not general duties.
  + Waiver cannot be unreasonable.
* Partnerships can ratify actions that constitute a breach of duty.
* The duty of loyalty cannot be eliminated.
* Cannot unreasonably reduce the duty of care.

1. Partnership Liabilities:
2. To Third Parties:

* Limited liability means that company assets alone will be used to meet company obligations.
* Partners in a general partnership may be held personally liable for a company’s debts.
  + Creditors must exhaust partnership assets before part personal assets may be used to satisfy claims.
* General Rule- each partner is jointly and severally liable personally for partnership liabilities.
  + This applies for actions by partners that are within the scope of the partnership.
  + UPA and UPA (1997) have slightly different formalations
  + Main limitation on liability is that the partner creating the liability must have been acting consistent with partnerships of this type.
    - SEE CLASS FOUR (4) SLIDES FOR STATUTE
* Partners are agents of the partnership.
* Third-party creditors first proceed against the partnership assets.

1. Enforcing Claims/Debts Against the Partnership:

* Creditors- first proceed against the partnership then to individual partners
* If one partner indemnifies or pays a debt, that partner can seen contribution from the partnerships.

1. Limiting Liability for the Partnerships:

* RUPA allows for the filing of a statement of authority- binding on third parties
  + This gives notice that certain partners may not have authority to bind the partnership.
* See LLP below.
* This does not apply to torts.

1. Partner Profits and Returns on Investments:

* Real returns are derived from the sharing of profits.
* General rule- profits are shared equally in the absence of an agreement.
* Capital Account:
  + How to deterinspectionmine equity in a partnership:
    - Amount contributed
    - Minus amount distributed
    - Plus profits credited
    - This is paid out on liquidation,
* Partnerships can arrange any profit sharing arrangement.
* Losses are shared in proportion to the partner’s share of the profits and the default rules state losses are shared equally.

1. Law Firm Partnerships:

* The problem is how to incentive all of the lawyers.
  + Finders- those attorneys finding work
  + Minders- organizational managing attorneys
  + Grinders- those doing the work.

1. Types of Partnerships:
2. General Partnerships:

* Summary- unstable, unlimited liability is a major drawback and general partnerships have a difficult time admitting new partners.
* Easy to form
  + No formalities for the operation of the partnership.
* Liability- joint and several principles apply
* General partnerships should have a partnership agreement.
* If the partnership’s assets are not sufficient to satisfy the debts, partners are jointly and severally liable for unpaid partnership obligations.
* General partnerships can be created through an express agreement or may arise from operation of law when the parties have entered into an arrangement having the legal attributes of a partnership.
  + Partnerships can arise through operation of law.
* Agreements to share profits is not a perequisite to proving the existence of a partnerships
  + This is the majority approach.

1. The Limited Liability Partnership: LLP

* The LLP cannot be formed by operation of law and a filing is necessary.
  + The LLP is similar to a general partnership.
  + The LLP is a general partnership with a partial shield of liability.
* Partners who have made full capital contributions are not required to pay additional funds when partnership assets are incufficient to satisfy creditor claims.
* LLP partners are protected against contract creditors.
  + LLPs have a shield of liability from other partner’s tort
  + Some states have partial shields- partners would then be liable to contract creditors.
  + Most states are full shield- partners are protected from contract creditors.
  + Partners are not jointly and severally liable for the malpractice of other partners.
    - LLPs still the partner’s personal assets to be exposed if they commit malpractice and the partnership assets are exhausted.
  + The shield does not protect the partnership from claims of former partners.
* Most states limit the LLP to professionals only.
* Professionals in an LLP are still liable for their own malpractice, but their responsibility for their partner’s malpractice is limited.
* In an LLP, once partners have made capital contributions, they are not personally liable for the debts of the partnerships.
  + The partners must have paid the full amount of their capital contributions.
* Arose from professionals who could not form an LLC
* In most states, the LLP is not a separate business form, but an option included in general partnerships statutes.
* Can elect for the partnership or corporate form of taxation.
* LLPs cannot arise through operation of law.
* LLPs must be in strict compliance with statutes.
* The trend in the LLP is for more liability protection.

1. Limiting Liability:

* LLP statutes are not uniform.
  + Some limit malpractice liability for fellow partners.
  + Others provide a full-shield to also limit contractual liabilities to just assets of the partnership.
  + Full-shield- insulates against contractual and malpractice liability of other partners.

1. Transferring Partnership Interests and Adding New Partners
2. Transferring Rights

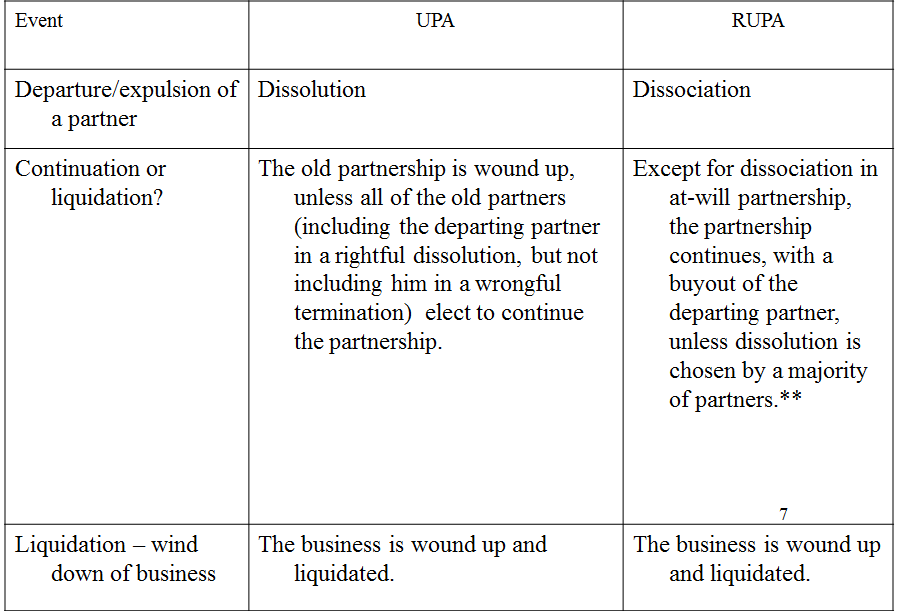
* Default rule- financial interests- profit interest and the right to capital interest on liquidation- are freely transferable
  + Management rights are not transferable.
  + This is consistent with the concept of partners having close personal relationships.
  + Financial interests can be sold and financial interests are freely transferable.
* Management rights are not transferrable without approval from all partners.
* Transferring the partner management rights requires the permission of all remaining partners.

1. Adding Partners:

* Default rule- Unanimity required to admit nw partner as a partner (with management rights) rather than just a holder of a financial interest in the partnership.

1. Ending the Partnership:

* Vocabulary:
  + Dissociation- refers to the withdrawal of a partner and the withdrawing partner has the right to be paid the value of his partnership interest
  + Dissolution- occurs when the partners decide to or are required to close down the business entirely
  + Winding up- refers to the process of closing down the business
  + Terminates- when winding up is completed- partnership completes work in progress, sells the company’s assets, pays creditors, and distributes the net balance to partners
* Partnership at will- a partnership without an official agreement
* Terminology:
  + UPA (1914)- dissolution, winding up, and termination
  + UPA (1997)- dissociation, dissolution, winding up, and termination



1. Dissociation:

* The dissociating partner remains liable for partnership obligations incurred during the time he or she was a partner.
* RUPA- in a partnership at will, voluntary notice to withdraw will trigger dissolution and winding up.
  + - All other dissociations give the remaining partners the right to continue the business.
  + CA-RUPA- half the partners including any rightfully dissociating must elect to dissolve and wind up the partnership; otherwise the mandatory buy-out rights apply and partnership continues.
  + UPA (1997)- dissociation means the withdrawal of a partner from the partnership
    - Consequences:
      * Remaining partners have the option of continuing the business (except withdrawal from the partnership at-will)
      * Withdrawing partner has the right to be paid the value of his interest
      * The dissociation is either permitted or it is wrongful
  + A dissociation is not a dissolution.
  + Partners in an at-will partnership are permitted to dissociate at any time and under RUPA trigger dissolution and winding up.
  + A partnership agreement may restrict dissociation
    - If so, wrongful dissociation can occur- partner may still dissociate in breach of the partnership agreement and be liable for damages for breach of the agreement
* Partners can dissociate at any time unless there is a formal agreement- can still wrongfully terminate.
  + Other Dissociations:
    - Partner may be expelled under the terms of the partnership agreement.
    - Death, incapaity, and breach of fiduciary duties
  + Except for an at-will dissociation, the remaining partners may continue the business and the withdrawing partner must be paid the value of his partnership interest, minus damages from wrongful dissociation.
* UPA (1997) Summary:
  + Dissociation does not automatically trigger dissolution except in a partnership at will.
  + Only certain events trigger dissolution and the default is for contination of the partnership.
  + Wrongful dissociation- the dissociating partner is subject to a reduction of his payment for the damages caused by is breach of the partnership agreement.
  + TOM TAKEAWAY- A partner may dissociate and demand his buyout price and just be liable for damages.

1. Dissolution:

* Dissolution- the commencement of the winding up process. Occurs when the partners decide to, or are required to, close down the business.
* In a partnership at will- a dissociation triggers a dissolution.
* Once dissolution begins, the partnership’s only business is closing down (“winding up”) the business.
* The partnership may be sold as a whole- business may still have good will.
  + Good will- difference between the actual assets and the value the business has as a whole- includes customer lists, relationships, etc.
* After widning up, the partnership is terminated.
* UPA/RUPA:
  + After dissolution, if there is no buyout, then dissolution continues and the winding up process commences.
  + A partner’s liability as a partner for liabilities of the partnership is ended as of dissociation. Partners may still be liable for debts incurred while incurred as a partner.

1. Instability of the Partnership: Exiting the Partnership

* Partnerships are unstable because compulsory buyout provisions give leverage to non-majority owners.
* Many agreements provide some means for exiting the partnership and require some payment.
* Partners have a right to be paid in cash the value of their interest.
* Tower snow problem- when law firm partners leave with clients.

1. Partnership Cases:
2. Holmes v. Lerner: Partnership by operation of law
3. Facts: (beauty products case)- Plaintiff claimed defendant breached partnership agreement resulting in her ouster.
4. Rule: An express agreement to divide profits is not a prerequisite to prove the existence of a partnership.
5. Holding: The oral partnership agreement was sufficiently definite to allow enforcement.
6. Meinhard v. Salmon (partner Fiduciary Duties)
7. Facts: Meinhard and Salmon were co-adventurers on a lease on a hotel, but prior to the expiration of the lease, Salmon alone agreed to lease the same and adjacent property.
8. Rule: Joint adventurers owe to one another, while their enterprise continues, the duty of the finest loyalty, a standard of behavior most sensitive.
9. Holding/Notes: Co-adventurers cannot be excluded if a fiduciary duty is owed.
10. Enea v. Superior Court: Partnership Fiduciary Duties
11. Facts: Enea claimed partners breached the fiduciary duty of loyalty to the partnership- to hold and rent real estate- by renting the property to themselves at less than fair market value, but the partnership agreement did not prohibit this.
12. Rule: Partners breach their fiduciary duty by engaging in deliberate conduct that has the effect of reducing partnership profits, even though such conduct is not expressly prohibited by the partnership agreement.
13. Holding/Notes: Partners owe each other the duty to carry out the enterprise with the highest good faith toward one another- may not engage in self dealing at the partnership’s expense.
14. Apcar Investment Partners VI, Ltd v. Gaus (LLP Liability Case)
15. Facts: Apcar contended that gaus was liable for breach of the lease because at the time the lease was entered into, there was not an LLP formed.
16. Rule: A limited liability partnership must be in strict compliance with statutory registration requirements for its partners to be shielded from individual liability.
17. Ederer v. Gursky: (Breadth of Liability Protection for the LLP)
18. Facts: Ederer, a former partner in an LLP, sought an accounting of his LLP interest, naming the LLP as well as the individual partners, who contended that the state statute shielded them from personal liability.
19. Rule: A statute that eliminates the liability of a partner in an LLP for “any debts” of the partnership, without distinguishing between debts owed to a third-party or a partnership or to other partners, does not shield a general partner in a registered LLP from personal obligations for breaches of the partnership’s or partner’s obligations to each other.
20. Casey v. Chapman (Transferring Partnership interests)
21. Facts: Casey purchased a pledged a partnership interest and contended that the successful bidder at a foreclosure sale and was entitled to receive only the profits of the partnership interest because not all partners agreed on the interest having voting and management rights.
22. Rule: Where there is no agreement by all the partners of a partnership that either the original assignee of a partnership or the successful bidder at a foreclosue sale selling the pledged collateral is entitled to anything more than profits, the successful bidder acquires only the right to receive profits allocable to the partnership interest sold.
23. Girard Bank v. Haley (terminating partnerships)
24. Facts: One partner tried to dissolve the partnership by letter and eventually died.
25. Rule: Dissolution of a partnership is caused by the express will of any partner.
26. McCormick v. Brevig (dissolution and accounting)
27. Facts: Partners, a brother and sister, were trying to dissolve the partnership and disagreed on the payouts.
28. Rule: When a partnership is judicially dissolved and when it is no longer reasonably practical to carry on partnership business, it must be liquidated by a sale of partnership assets and distribution in cash of any surplus to the partners.
29. Horne v. Aune: winding up of partnership
30. Facts: Plaintiff claimed that the partnership statute required a forced sale of the property that precluded one partner from buying another out.
31. Rule: The RUPA winding-up provision does not require the public sale of partnership property, so that a court may instead allow a partner to purchase the property for its agreed value with cash payment to the other partner of his partnership interest.
32. Financing the Business:

* A business can raise capital through contributions of owners or by borrowing money from third-party lenders or company owners.
* Obligations to creditors- including those who are a partner- are recorded in the balance sheet.

1. Unincorporated Forms:
2. Unincorporated Forms:
3. Private Company:

* Stock held by few owners
* No liquid market for stock
* Mostly shareholder managed
* Monitored by owners

1. Public Companies:

* Stock held by many- stock with a ready market
  + Shares of the corporate stock are easily traded.
* Liquid market
* Managed by professionals
* Institutional shareholders

1. Government Corporations:

* Corporations that are either wholly or partly owned by the government. (amtrak, USPS)

1. Nonprofit corporations:

* Nonprofit corporations do not have shareholders of any kind.
* Profits cannot be paid to members are dividends.
* Examples- universities, hospitals
* Two types:
  + Charitable- does not pay taxed on profits
  + Mutual Benefit- taxes are not deductible by the contributors

1. Closely-held corporation- privately held corporation

* Close corporations are a statutory creation.
* Close corporations are a special kind of closely held corporation
* See Class 6 slides if in a bind.
* Shareholders in a closely held corporation take a personal or long term interest in the corporation and see themselves as an owner in the direct sense
* Allowed greater latitude than publicly held corporaions in their internal management.

1. Public corporation- widely held- publicly held corporation
2. Close corporations

* Unpopular but still used.
* If the corporation has under a certain number of shareholders corporate formalities can be relaxed.
* Operated like a partnership.

1. Professional corporations

* Limited to licensed professionals
* Only licensed professions in the area of the practice of the corporation can own stock.
* Examples- Law firms
* Same liability rules as the LLP.
  + The practitoners are not shielded.

1. Limited Liability Company: The newest entity.

* Tom Says- Has it all!
* Offers greater protection than the LLP because the LLP does not protect a professional from negligence.
* The LLC is an effort to achieve favorable tax treatment while combining the best of the partnership and corporate form.
* The LLC may define or limit the scope of fiduciary duties.
* Managers owe duties of loyalty to the LLC.
  + Duty of loyalty also applies to managers-managers
* A pass through entity for taxation
* All states have passed LLC acts.
* Limited liability- for everyone involved
* One level of tax
  + Usually qualifies for partnership pass through taxation
* Flexible
* Single Member LLCs are acceptable.
* Check the box election- can be taxed as a partnership or a corporation
* All owners can manage the enterprise- like a general partnership
  + Can still provide for a manager-managed LLC- like a corporation
* General Philosophy:
  + Emphasis on freedom of contract
  + Statutory default rules apply in absence of an operating agreement.
  + There is an ULLCA, but the state statutory default rules are not as uniform.
  + CA adopted the RULLCA on 01/01/2014.
* Majority owners owe fiduciary duties to minority owners- may only apply in closely held corporations
* Members are liable for the full amount of their promiused contribution
* Members may transfer their shares, but the transferee does not become a member unless the other members consent or the operating agreement allows for it.
* (Anderson v. Wilder) Court finds that majority owners owe fiduciary duties to minority owners.

1. History of the LLC:

* Wyoming adopted first LLC statute in 1977
* See class sides seven for a complete history.

1. Facts of the LLC:

* One person can form an LLC
* Executing the operating agreement was not a prerequisite to becoming a member of the LLC.
* Simple to form- but organization can be as complicated as a partnership
* Flexible
* Can be management by the many or management by the few
* In DE, LLCs can expand or restrict the duty of managers but they cannot eliminate the duty of good faith and fair dealing.
  + In CA, the fiduciary duties of a managers are the same as those in a partnership.
* Financial interests are transferable
  + Membership is not transferable without consent of members
* Dissociation can occur under ULLCA but not under DE LLC act.
* LLCs have formal prerequisites:
  + Filing certificate of formation required.
  + No shareholder meetings or board meetings are required.
* General partnerships can easily be converted into a LLC
  + Some courts have applied corporate veil piercing standards
* The LLC is so new that many matters are matters of first impression.
* Statutory Provisions:
  + An agreement to form an LLC is not itself an operating agreement. The term “operating agreement” presupposes the existence of members, and a person cannot have “member” status until the LLC exists.
  + •But, “operating agreement” is broadly defined. As soon as the LLC has members, the limited liability company has an operating agreement.
  + –Example: (i) two persons orally and informally agree to join their activities in some way through the mechanism of an LLC, (ii) they form the LLC or cause it to be formed, and (iii) without further ado or agreement, they become the LLC’s initial members. The LLC has an operating agreement. “[A]ll the members” have agreed on who the members are, and that agreement – no matter how informal or rudimentary – is an agreement “concerning the matters described in Section 110(a).” (To the extent the agreement does not provide the *inter se* “rules of the game,” this Act “fills in the gaps.” Section 110(b).)

1. Formalities of the LLC: Managing the LLC

* Emphasis on freedom to contract
* Can be member or managed managed
* Voting is by profits interest
* Modifying the operating agreement requires unanimity
* Certificate of formation is required.
* Signing of the agreement is helpful but not dispositive of membership.
* Moon Note Case:
  + Moon did not sign the agreement but his conduct evidenced his intent to be a member of the LLC. He was held to the terms of the agreement.
* Operating agreements are not required but they are a good idea.
* ULLCA:
  + Any manager in a manager-managed LLC is an agent of the LLC
  + Any member in a member-managed LLC is an agent of the LLC
  + Fiduciary duties of the ULLCA- see class eight slides. (resembles the partnership)

1. Removal of Managers in an LLC:

* Because the LLC does not have required management formalities, conduct can demonstrate consent.
* In Re De Luca:
  + Court finds that the conduct of the De Luca’s showed unanimous consent to admit NVR as a member (page 167).

1. Dissociation and Dissolution in the LLC:

* Any member can dissociate at will
* Look to the operating agreement for a potential breach
* The member leaving loses their management rights
* If one member is expelled, the entity does not have to be dissolved.
* Dissolution is not a remedy courts rush into.
* ULLCA allows for any member to dissociate at will and it is only wrongful if it breaches a provision of the operating agreement.
* Under ULLCA: Dissolution and Dissociation:
  + Member ceases to have management rights
  + Becomes holder in economic rights only.
  + Member is not statutorily entitled to have his interest purchased.
  + LLC not dissolved.
    - Not all states have adopted the ULLCA
* In DE- a member may resign only as provided in the LLC operating agreement.
  + On resignation- operating agreement governs but
  + If operating agreement is silent, then member receives fair value of interest on date of resignation based upon his right to share in the distribution.
* (Dunbar) Finding of “not reasonably practicable to carry on the business” does not require a finding of wrongful conduct.

1. CA LLCs:

* Formation- File articles of incorporation in CA
* Can be member or manager manged.
* Operating agreement will control in most instances.
* When there is no operating agreement:
  + Voting is by profits interests (except transferee- member retains voting interest if transferee not admitted as a member)
* No member, manager, or officer has personal liability for LLC’s obligations.
* Withdrawn mamber not entitled to payment unless provided for in articles or operating agreement
* Membership interests are assignable unless operating agreement prohibits or restricts
* Forced removal or dissolution is possible under the similar rules as Dunbar.
* Only manager (or member managed) has fiduciary dties to LLC- same as those of partner to a partnership (but not to members just to the LLC)

1. Subdivisions of the LLC:

i. Social Enterprises:

* AKA Mission driven companies
* Social enterprises use market based strategies to finance the achievement of social goals.
* Unlike non-profits, social enterprises can distribute company profits to equity investors.
* Unlike business organizations, social enterprises engage in profit making activities to accomplish social objectives.
* Social enterprises give equal weight to profit making and social objectives

1. Low Profit Liability Company (L3C)

* Created to enable foundations and other nonprofits to provide support to small business organizations formed primarily for charitable or educational purposes.
* The L3c must meet the following criteria:

o The company must be organized for a business purpose

o The company must be formed to accomplish charitable or educational purposes as defined by the IRS

o The company may produce income but it cannot be a primary purpose.

1. Benefit Corporation:

* Use business models to solve problems benefitting society at large
* It is a corporation whose company documents have been amended to formalize its commitment to social responsibility
* The company must undergo an independent audit using a social responsible rating system.
* The internal affairs doctrine is critical
* Combines a mission of enhancing shareholder value and a positive social or environmental purpose
  + Some corporations can have missions but they are not benefit corporations.
* Founders and investors have aligned on core values.
* Three added elements: social purpose, accuntability, transparency
* CA requirs a general public benefit
  + DE- requires a public benefit and to operate in a responsible and sustainable manner.
  + CA requires yearly assessment under 3rd party standard.
  + DE- board can set its own criteria.
  + CA yearly report to shareholders and the public.
  + DE- no public report, and it is bianual.
  + CA also has a flexible purpose corporation with less reporting.

1. Limited Partnerships:

* Limited partners are passive investors whose liablity was limited to the amount of capital contribution.
* General partners have full responsibility and have unlimited liability for obligations.
* Can be taxed like corporations or partnerships
* This was the first hybrid corporate form. Today, these have morphed into the LLC.
* Encourages passive investment by those who will not manage the enterprise
* Basic Statute is the RULPA
* Rules of general partnerships apply to general partners.
* Cannot be created informally- requires certificate of formation to be filed.
* A written agreement is crucial
* Passive investors- limited partners- must remain passive to avoid liability as general partners.
  + Now, general partners also have limited liability.
  + Limited partners can now participate in management and have limited liability.
* Statutory provisons are generally amed at protecting creditors.
* RULPA- provided for LLLP- limit partners are shielded from liability based on their status as limited partners.
* See class slide 6 for statutory provisions.
* One becomes a limited partner by contributing capital.
* Profits and losses are shared according to capital contributions.
* Limited partners are liable to creditors only for failing to honor contribution obligtions or controlling the entity.
* Limited partners have no statutory voting rights except for self-dealing transactions.
* Passive investors- limited partners no longer are required to remain passive to avoid liability as a general partner.
* ULPA (1916):
  + A limited part shall not become liable as a general partner unless he takes part in the control of the business.
* RULPA (2001):
  + A limited partner is not personally liable even if the limited partner participates in the management and control of the limited partnership.
* Profits and losses are shared according to capital contributions.
  + Differs from general partnership.

1. S Corp:

* Single level tax
* Limited to 75 shareholders
* Only US citizens or residents

1. Introduction to the Corporate Capital Structure:

* Stock:
  + Common Stock- the first class of stock which represnts the ownership
  + Preferred Stock
* Debt:
  + Convertible into stock if desired.
* Rights to acquire capital stock or debt- with vesting

1. Cases:
2. Elf Atochem North America v. Jaffari: (LLC Case)
3. Facts: Elf disputed that all claims against the LLC and members were to be arbitrated in CA.
4. Rule: Because the policy of the DE limited liability company act is to give maximum effect to the principle of freedom of contract and to the enforceability of LLC agreements, the parties to such agreements may contract to avoid the applicability of those provisions of the act that are not prohibited from being altered.
5. Holding/Notes- Maximum emphasis is placed on freedom to contract. Flexibility is emphasized.
6. In Re Deluca:
7. McConnell v. Hunt Sports Enterprises: LLC Non-Competition Case
8. Facts: (see slides class 7- slide 15 for detailed facts) Members of an LLC were trying to apply for a hockey team and sought a declaration for breach of contract.
9. Rule: A member of a limited liability company does not breach a fiduciary duty to the company by directly competing against it where the operating agreement expressly permits competition.
10. VGS, Inc. v. Castiel (LLCs)
11. Facts: Argued two managers breached the duty of god faith when they tried to perform a merger without telling a third manager.
12. Rule: The managers of a limited liability company owe to one another a duty of loyalty to act in good faith.
13. Notes/Holding: Majority shareholders may owe a duty to giv proper notice and cannot act secretly.
14. Anderson v. Wilder: (LLC duties)
15. Facts: Minority members of an LLC claimed that majority members breached their fiduciary duty of loyalty when they were expelled.
16. Rule: Majority member of a member managed closely held corporation owe minority members a fiduciary duty, which must be discharged in good faith.
17. Lieberman v. Wyoming.com LLC (problems in dissociation)
18. Facts: Lieberman contended that his withdrawal from the LLC did not divest him of his equity interest in the LLC.
19. Rule: The withdrawal of a LLCs member from the LLC does not divest the member of his equity interest in the LLC where the LLC tatute is silent on the rights and obligations of members upon the dissociation of a member and the operating agreement does not provide for a buyout.
20. The Dunbar Group, LLC. v. Tignor (dissolution and the LLC)
21. Facts: Dunbar claimed that its request to dissociate did not warrant a dissolution.
22. Rule: Dissolution of a LLC is not warranted upon the expulsion of a wrongdoing member where evidence shows that it is reasonably practicable to carry on the LLC’s business.
23. Corporations:
24. Definition and Background: Corporate Documents Must be Stamped by secretary of State

* A corporation is an entity that consist of an intangible structure for the conduct of the entity’s affairs and operations, the essence of which is created by the state, and that possesses the rights and obligations given or allowed to it by the state, which rights and obligations parallel those of natural persons.
* The corporation is an entity with a legal status separate and distinct from the people who comprise it.
* A corporation is a nexus of contracts.
* The rights and obligations are given or allowed by the state- largely parallel those of natural persons
* Key elements- It is an entity separate from its owners and it is created by the state.
* A corporation is a separate legal entity- its own person
  + Corporations have the right to free speech
  + Corporations have the right against unreasonable searches and seizures.
* Corporations are responsible for its own obligation.
* Corporations possesses its own rights.
* Why are corporations so popular:
  + Incorporations are free- no special legislative act required
  + Limited liability
  + Well structured which lowers transaction costs.
* The corporation must be created by the state.
* Citizens United- corporations have the same political rights as individuals.
* Major Themes of the Corporation:
  + Separation of ownership and control- resulting in agency costs
  + Short-term v. long term focus
  + Society’s interests being met by corporations
  + Benefit to other corporate constituencies
  + Regulation v. Entrepreneurism
* Powers of the Corporation:
  + Corporations can engage in any lawful business, other than banking and trust company business.
  + Powers used to be limited and actions beyond those powers could not be enforced.
    - Known as the Ulta Vires doctrine (largely archaic doctrine today due to broad power statements in the charter)
    - Charitable donations and loans to officers and employees were once Ulta Vires

1. Historical Background:

* Corporate statute were originally restrictive and now enabling.
* Movement toward free incorporation for any industry
* Delaware emerged.
* Corporations offer a wide choice of limited liability entities.
* The Quiet revolution= the emergence of limited liability
* The Emergence of DE:
  + Originally, NJ was the key corporate state.
  + DE has a court that only hears corporate cases- judiciary adds a level of stability.
  + DE only taxes profits from those earned in DE
  + DE has a corporate friendly statute.
  + DE’s tax structure beats the competition
  + DE’s secretary of state is fast and efficient.
* Statutes moved toward a free incorporation for any industry
* Movement from restrictive to enabling statutes
* Movement from unlimited to limited liability.
* Delaware emerged as the corporate hotspot.
* Race to the bottom- idea that only managers are benefitted from the corporation
* Race to the top- shareholders are benefitted
* States compete with one another because corporate statutes are not uniform.

1. Advantages and Disadvantages of the corporate form:
2. Advantages:

* Limited liability of shareholders
* Centralized management- ownership and management rights are different
  + Different from partnerships where ownership and management rights are intertwined,
* Flexible capital structure
  + Simplicity and flexibility makes the corporate capital structure adaptable to almost any business requirement.
  + Easy to admit new owners
  + Easy for owners to exit
* Perpetual life of the company:
  + The death or bankruptcy of an owner has no effect on the corporation.
* Stability
* Scope of limited liability for sahreholders:
  + Shareholders have limited liability
  + Limited liability means the corporation is solely responsible for its obligations and the personal assets of the sahreholders will not be used to satisfy corporate debts.

1. Disadvantages:

* Continuing the formalities- this is a minor disadvantage
  + Meetings must be held and minutes must be kept
* Tax treatment
  + This can be slightly mitigated
    - Through the Special S Corp Election
    - Reinvest cash profits back into the business to avoid double taxation
  + Corporations have double taxation
  + A corporation is subject to federal income taxation on its earnings
  + Dividends are are subject to taxation as the ordinary income of shareholders
  + Double tax- income taxed when earned by the corporation and again when distributed to shareholders.
* Management of expenses and distributions.
  + Costs associated with incorporated and doing business in a particular state
* Partners jointly liable to third parties.
  + Possible to contract for a structure that resembles limited liability.

1. Corporate Management:

* Most corporations will not change the default rules.
  + In statutory close corporations, this structure can be dispensed with.
* Management rights are generally de-coupled from ownership.
  + This allows for the free transferability of shareholder interests.
* Incorporator- individual who files with the state
* Internal Affairs- the relationship between the corporate players

1. Shareholders

* Approve or veto extraordinary transactions- no authority to initiate action other than disolution or a lawsuit to oust directors
* passive investors of capital that elect directors and approve certain corporate actions- voting is directly tied to the amount of the capital contribution

1. Directors

* Board of directors- the brains of the corporation
* Set policy and direct management
* Directors elect officers

1. Officers

* Administer directives of the board

1. Internal Affairs Doctrine:

* For corporate law, the “internal affairs” rule holds that the law of the state of incorporation governs for internal governance matters such as management, financial matters, and fiduciary duties. This is regardless of where the corporation does business.
* The internal affairs doctrine is a long-standing choice of law principle that recognizes that only one state should have the authority to regulate a corporation’s internal affairs- the state of incorporation.
* Only the law of the state of incorporation governs.

1. Promoters:
2. Definition:

* A term of art applied to a person who organizes a business- describes the founders or entrepreneurs
* Promoters are entrepreneurs responsible for bringing together all of the components required to transform a business opportunity into a business operation.
  + Finds investors
  + Plans the organization’s legal structure and has the forms prepared.
* Promoters do business and enter into contracts before there is an official corporate entity.
* RMBCA: 2.04
  + All persons purporting to act… on behalf of a corporation, knowing there was no incorporation under this ACT, are jointly and severally liable for all liabilities created while so acting.

1. Promoters Contracts:

* The promoter is liable up until the corporation is formed and continues to be liable even if the corporation adopts the agreement.
  + If the corporation adopts the agreement, the promoter is not absolved.
* All parties expect that the corporation will be responsible for contract performance but the promoter is personally liable.
  + The corporation can either accept or reject the contract.
* The corporation is not liable until after it is legally incorporated and takes some action to make the contract its own. Through:
  + Ratification (retroactive)- accomplished formally when the board of directors adopts a resolution saying that the acts of the promoter in executing and delivering the contract are ratified.
  + Adoption- may adopt informally or formally
    - Formal- the board of directors passes a resolution stating the contracts is adopted.
    - Informal- newly formed corporation performs the contract’s obligations with knowledge of the terms.
* Regular contract assignment rules apply.
  + Promoter still liable even if corporation adopts agreement unless:
    - There is a novation after the formation of the corporation OR
    - Automatically as drafted in the original promoter’s contract
* Promoters are generally personally liable under promoters contracts because a corporation cannot be bound if not in existence.
  + Same agency principles
* Absent a novation, the promoter will remain liable along with the newly formed corporation.
* To protect the promoter from liability, the promoter must: (1) include language contemplating an automatic novation upon the corporation’s adoption of the contract; (2) a novation either informal or formal must be effected
* Looking for what the parties intended cannot be taken literally because even if the parties intended for the corporation to be liable, the promoter is still liable.
* Parties can draft an option that the corporation can enter into.

1. Where to Incorporate:

* Three factors to consider:
  + Substantive provisions of state incorporation law
  + Costs of incorporation in another state
  + Plan- Forecast- Whether the company will be closely or publicly held
* The internal affairs doctrine is important.
* Other considerations of where to incorporate:
  + Substantive provisions in state law
  + Costs of Incorporating in another state
    - Incorporation fees paid to state of incorporation and
    - Qualifying to do business fees paid to state where business is located
    - And annual fees paid in both jurisdictions.
    - Internal affairs doctrine:
    - Corporations will be deemed to be a foreign corporation to states other than the one it is incorporated in.
  + Domestication- refers to the process used to change a corporation’s state of incorporation

1. How to Incorporate:
2. Incorporation

* Avoid standardized forms
* A corporation must keep a registered office and a registered agent for service.
* Attorneys must check statutes on home state and state of incorporation.
* Domestication- refers to the process used to change a corporation’s state of incorporation

1. Formation:

* The purposes clause designates the type of business which the company may conduct- only lawful business

1. Pre-incorporation agreements (see promoters)

* The agreements spelling out the important terms, financing agreements and other aspects the organizers have agreed to.
* Agreements before the company is formally incorporated
* Usually, the agreement terminates upon incorporation
* Used when it may take time to incorporate

1. Defective Incorporation:

* Doctrines arose when there were many procedures for establishing a corporation.
* Some states abandoned curative doctrines- MA abolished
* Some states reaffirmed those doctrines.
* MA appears to abolish the doctrines.
* De Facto Corporation: 3 Elements: Equitable doctrines apply

1. There is a law allowing for incorporation.
2. Good faith attempt to incorporate under the law (usually where cases arise)
3. Corporate power used in honest belief that corporation existed.

* Becoming less relevant because corporations can be established in one easy step.
* Persons acting on behalf of corporation knowing that it does not exist will have liability.
* Corporation by Estoppel:
  + Doctrine: persons who treat entity as a corporation will be estopped from later claiming that the entity was not a corporation
  + Unlike de facto corporations, estoppel is applied in a case by case basis between two parties to equitably resolve a dispute
  + Generally, the doctrine does not apply in tort cases.
  + A court applying this doctrine will estop defendant from arguing the nonexistence of a corporation that patently does not exist.
  + May apply when both parties believe they are dealing with a corporation

1. Cases:
2. 1. McArthur v. Times Printing Company: (Promoter Case)
3. Facts: Times contracted with McArthur for his services as advertising solicitor for one year and subsequently discharged him.
4. Rule: Formal adoption or acceptance of a contract by a corporation is not a requirement, but acceptance may be inferred from acts or acquiescence on the part of the corporation, or its authorized agents.
5. Holding/Notes: The agreement must be one that the corporation would make and one that the corporation’s agents have express or implied authority to make
6. VantagePoint Venture Partners 1996 v. Examen, Inc. (internal affairs case)
7. Facts: Vantage, a preferred stock holder of Examen (a DE corporation) contended that CA had a constitutional right to regulate a shareholder vote on Examen’s merger. The dispute was over which state’s substantive law controlled on the merger.
8. Rule: The internal affairs doctrine requires that a merger vote be governed by the law of the corporation’s state of incorporation.
9. Holding/Notes: The internal affiars doctrine also has a due process element because officers, directors, and shareholders need to know what law will be applied.
10. Corporation Capitalization:
11. Definition:

* Capitalization- the cash or other assets put into the corporation on a long-term basis- consists of equity and debt
* The assets put into the corporation for equity or debt.
* Authorized number of shares must be specified in the charter.
* Directors have the power to issue shares.
* Corporations either raise capital by either selling shares (pieces of ownership) or borrowing.

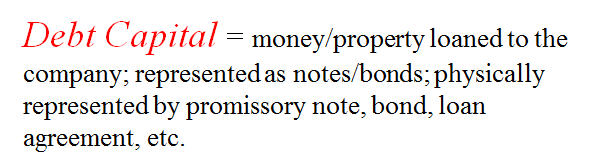
1. Types of Capital:
2. Debt Capital:

* Debt- cash or other assets that are borrowed.
* Money or property loaned to the company.
* Represented usually by notes or bonds.
* Physically represented by the promissory note, bond, loan, agreement.
* The debt must be cleared out before the corporation has value.

1. Equity Capital

* Equity capitalization- the cash or other assets contributed by shareholders in exchange for stock
  + Equity- an ownership interest in the corporation
* The “upside”- the value when residual claims are paid.
* The price per share must be the same for everyone.
  + Otherwise, may be confused as gifts.
* Everyone must pay the same price for their equity
* Equity has value only after fixed claims have been paid.
* Money or property paid in.
* Represented as common or preferred stock.
  + Typically represented by some form of security (stocks)
* Physically represented by a stock certificate

1. Slide:



*Equity Capital* = money/property paid in; represented as common or preferred stock; physically represented by a stock certificate.

1. Equity Capitalization: (Stock):

* A corporation can’t issue more stock than what is authorized.
  + The total number of shares must be specified in the charter.
  + Only the directors have the power to issue authorized shares.
* Issuance of stock- the original sale
* The starting point for capitalization is the corporate statute
* Stock represents ownership rights- the right to vote and consent to certain corporate actions

1. Stock: Types:

* Shares can be divided into classes and series.
* The board of directors has the authority to issue stock.
* There can be fractional shares. (.33 of stock)
* Classes and series must be described in the charter.
* TOM KEY CONCEPT- Not anyone can buy stock. private companies can decide not to sell stock to anyone for legitimate reasons.
* (Katzowitz)- There must be a reasonable business purpose for offering stock at below market value.
  + Personal purposes to benefit the shareholders is not a reasonable purpose
  + The reason must be related t the corporation

1. Common Stock

* Those owning common stock are owners of the company
  + Have voting rights
* Paid after creditors have been paid

1. Preferred Stock (closer to debt)
   * Preferred stock is a contract. Rights are preferred or negotiated.
   * Preferred stock will usually have priority over the common stock as to shareholder rights to receive assets if the corporation is dissolved.
     + May receive dividends- owners do not share in successes above an agreeed level
   * May not have the right to vote but if dividends are not paid, the preferred stock holders may have the right to elect new directors.
   * No default rights of preferred stock.
   * Preferred stock is similar to a contract- the rights are negotiated.
   * Two Types of Preferred Stock:
2. Cumulative preferred-Form of debt- pays a big dividend- pays before common stock- common in industrial incorporations. The stock is below the creditos.

* Paid order- Loanà cumulative preferred stock -à common stock

1. Venture Preferred (used in CA)- series A, B,C, etc.

* There is a liquidation preference (gets money back first before common stock)
* Usually, there is a right to convert into common at a specified ratio- starts at one share of preferred to one share of common
* When converting, the holder will give up their preference.
* Venture preferred protects on the downside, but if the company is sold, can convert into common for profits.
* Gets to vote with the common
* Can elect a director- series A
* Holders have protective provisions- veto rights
  + Examples of Rights:
    - Liquidation preference- the right to get the amount paid for the preferred stock back first in the event of a sale or liquidation of the company.
    - Voting Rights:- to vote with the common stock on an “as-converted” to common stock basis
    - onversion right- right to convert common (and give up some preferred rights\_ at any time at the then current conversion ratio.
  + Preferred Voting and Veto Rights:
    - None by default except when a class vote is required by law.
    - Needs to be written in the charter.
    - Veto rights= protective provisions= negative covenants
      * Will not sell or merge the company without a majority preferred stock vote
      * Will not amend trhe charter without such vote
      * Will not borrow over a certain dollar amount with such vote

1. Warrants, Options, and Rights

* Warrant- stock purchase warrant or subscription warrant- is a type of security, usually listed together with a bond or preferred stock, that entitles the holder to buy a proportionate amount of common stock at a specified price, usually higher than market price for a period of years.
  + Freely transferable
  + Do not provide voting rights or dividends
* Right- subscription rights- are similar to warrants because they are transferrable and listed on the securities exchanges.
* Rights are usually short-term options- (different from warrant) providing the holder with the opportunity to purchase common stock at below market or below issue price.
* Rights may be made in lieu of dividends.
  + The typical right is the right to acquire a set number of shares for a fixed price for a specified period of time.
  + Put option- right to sell at a set price

1. Consideration for Stock:

* All states of consideration are valid- cash, property, cancellation of a debt
* Some states- fully secured obligtion
* RMBCA 6.21(b)
  + “any tangible or intangible proprty or benefit to the corporation.” (guarantee)
  + DE- same as RMBCA
  + CA- not promissory notes unless fully secured, nor future services constitute payment

1. Duly Authorized, Validly Issued, Fully Paid, and Non-assessable stock:

* Duly authorized- means that when the shares were issued, the corporation had sufficient shares authorized in its charter to cover the issuance.
* Validly issued- that the issuance of shares was in accordance with corporation law.
* Fully paid- the appropriate type and amount of consideration that was to have been paid upon issuance has been paid.
  + If fully paid, the owner cannot be assessed for further payments.
* Assessable stock:
  + Rarely, a corporation may specify that it has the right to demand future payments from the holder of the stock.
  + Stock can also be assessable if the proper type and amount of consideration that was to have been paid upon its issuance was not paid.
  + Stocks can be held in escrow for future services
* Watered stock- shares issued for less than the full amount of permissible consideration set by the board

1. Par Value: (no concept in CA)

* A dollar figure specified in the charter from which certain well-defined consequences flow.
* The amount of capital that came into the corporation (base foundation) that corporation could not use to pay dividends
* Creditors used par value to determine the strength of the company
* Articles of incorporation indicate whether there was par or no par stock.
* Par value stock cannot be issued for less than par value
* Money from sale of par value stock had to go into special account called stated capital which account could not be reduced below the aggregate par value of such stock by dividends or distributions (otherwise the directors were personally liable for deficiency)
* State capital- par value capital- amount of money collected from stock purchases that company could not issue dividends from
* The board of directors is personally liable for selling stock at less than par value.
* A way to compute annual tax on the corporation.
* Par Value Today:
  + There is no significance today except certain states including DE and NV assess an annual franchise fee- a fee or the privilege of being incorporated or doing business in that state- based on par value, or for no par value stock based on assumed par value.
  + States with a concept of par value often have a related restriction on dividends or distributions being paid out of par value capital.
  + RMBCA/CA- eliminated the concept of par value
  + Unpaid par value- creditor or bankruptcy trustee can go after unpaid par value amount
* Consequences of Par Value and effects on corporations:
  + Stock typically cannot be issued by the corporation for less than par value
  + When par value shares are issued, a dollar figure equal to par value is shown on the corporation’s books.
  + Fees and taxes payable to state of incorporation are often based on par

1. Debt Basics:

* Debt is a contract- No ownership interest in the corporation.
* Debt represented by notes may be secured or unsecured.
* Bonds (secured)
* Debentures (unsecured)- usually connected to an indenture.
* Bonds and debentures may be made payable to a holder ( a bearer bond- no longer in wide use) or registered to holder (a registered instrument)
* May be convertible into stock at some future time or event
* Terminology- coupon- interest rate at issue price
* Principal- base amount of debt
* Maturity- on demand or a stated date- date when bond becomes due

1. Types and Effects of Debt:

* Debt capitalization involves corporate borrowing.
* The lender may be an independent third-party or a shareholder of the corporation.
* The principal- the borrowed amount
* The most common forms of debt capitalization are short term and long term loans from banks, private investors, or shareholders to the corporation
* · Bonds and Debentures:
* Bonds or debentures differ from a note in that holders are protected by contractual provisions contained in an indenture covering a multitude of corporate matters.
* Indenture- a contract between the corporation and the indenture trustee, usually a bank, that acts for the benefit of the hold or debenture holders
  + Indenture governs the rights of all bond owners.
  + The trustee handles the negotiated bonds
* Bonds:
  + May refer to long term debt instruments of five to ten years or more
  + Bond is also used to describe a long-term debt instrument secured by a mortgage or deed of trust on corporate property
  + Bearer bonds (outlawed)- whoever held the bond was the owner
  + Convertible bond- can be traded publicly- bonds that allow the holder to purchase stock at some time or future date
* Debenture:
  + An unsecured long term debt instrument
* Interest payments on debt are taxed deductible while payments on dividends are not.
* ·If the corporation goes bankrupt, the debt holders have preference or can possibly qualify as an income tax deduction.
* Corporations want to split their contributions between equity and debt.

1. Short Term Debt:
2. Bank Loans:

* Corporations, especially smaller ones, obtain short-term resources by taking loans from commercial banks.
* Short term loans can be renewed.
* Tend to involved less extensive documentation and complexity

1. Trade Credit:

* The extension of credit from suppliers of raw materials or inventory or other inputs into a corporation’s operations.
* The buyer may be required to pay the supplier within a certain period of time.
* Generally, short-term, unsecured, and in ongoing relationships.

1. Commercial Paper:

* Commercial paper- the issuing of promissory notes in large amounts, usually at least 100K, payable within short time frames
* Buyers of commercial paper may include other corporations with cash surpluses.
* Considered low risk debt

1. Long Term Debt- Beyond Equity and Debt:
2. Leases:

* Leases are a substantial source of corporate finance and are an alternative to buying real property, equipment, or other resources.

1. Convertibles:

* A hybrid security where the investor is given the right to convert the debt or preferred stock into common stock.

1. Asset Backed Securities:

* Asset backed securities- refer to instruments whose pay out of interest and principal to investors comes from cash flows on particular assets set aside for that purpose.

1. Derivatives:

* Derivative instruments- a device whose economic value is not determined solely by reference to some direct reference like a corporation’s value but according to change in value of some other instrument or benchmark.
* Options can be characterized as derivatives.
* All derivative arrangement are private party contracts consummated using a relatively standardized set of legal form contracts initially developed by a trade association

1. Leverage:

* Leverage- used to describe the financial consequences of the use of debt and equity.
* The use of debt creates financial leverage for the equity. The greater the debt the greater the leverage.
* The greater the leverage the greater the potential gains and losses for equity and greater the risk of loss for the debt.
* The equity holder has a residual claim- a right to what is left over after the debt holder’s claim is satisfied.
* Leverage increases the amount of risk in a particular transaction.
* The higher the ratio of debt to equity, the greater the impact of leverage.
* Concept increase return to equity by increasing debt.
  + Can borrow and use the debt to pay the operations. If operations are successful, the fixed claims can be paid, and the dividends then issued.
* Some debt benefits the corporation
* A mortgage is the most common leveraged transaction.

1. Thin Incorporation:

* Concept- too much debt compared to equity
  + The IRS may treat the debt as equity
  + The debt would be characterized as risk capital- debt is pushed down and subordinated to other creditors.
* Shareholders do not want to exist in a thin corporation. The consequences fall into two categories:
  + The IRS may consider the debt to be equity for tax purposes causing interest payments on the debt to be treated as nondeductible dividends.
  + A court may subordinate a shareholders debt to that of other creditors in the event of bankruptcy
* Whether a company is a thin incoproation is whether the company is finaced with debt and equity and some portion of debt consists of loans from shareholders
* The issue is whether the debt is disguised as a loan.

1. Pre-emptive rights/Share Transfer Restrictions and Buyout Agreements
2. Pre-emptive rights

* ·Pre-emptive rights enable shareholders to maintain their proportionate ownership interests in a corporation when the company sells new issues of stock.
* A right to continue to buy additional shares of stock to keep the same ownership interest.
* Shareholders with pre-emptive rights are given the opportunity to buy a proportionate share of new stock, so that their ownership interests will not be diluted.
* These rights are especially important in a closely held corporation
* Statutes take three approaches to grants of pre-emptive rights: the grant of rights is mandatory, preemptive rights are not granted unless the corporate charter provides to the contrary (opt out provision) or the rights are granted only if the corporate charter elects them (opt-in provisions).
  + Classes: opt-in, opt-out, Right of first offer
* RMBCA, CA and DE do not mandate pre-emptive rights
  + They are opt-in statutes
* Model Business Code provides:
  + If pre-emptive rights are provided, they can be waived
  + If prememptive rights are granted, the following excetions apply unless charter provides otherwise:
    - shares issued as compensation
    - shares issues within 6 months of incorporation
    - shares issued for property other than money
    - non-voting shares do not have pre-emptive rights
    - shares not subscribed for may be sold within one year period of the offer.
* Dilution:
  + One form of dilution is offering new stock.
  + Voter dilution- when the voting dilution may decrease but the value of the company may increase.

1. Share Transfer Restrictions and Buyout Agreements:

* Used most commonly in closely held corporations. The purpose is:
  + Give remaining shareholders control over who will become shareholders when one or more want to liquidate ownership interest
  + Provide a mechanism for liquidating the interests of shareholders who die or want to terminate their relationship with the company.

1. Share Transfer Restrictions

* MA authorizes share transfer agreements
* May be prohibited entirely
* Share transfer restrictions control who becomes an owner.
  + Important in closely held corporation
* Share transfers may be mandatory upon a certain event occurring.
* Basic typs of transfer restrictions:
  + First refusal rights
  + First option rights- at a pre-determined price
  + Consent restraints
  + Buy-sell death or separation from employment in favor of company and/or other shareholders.
  + Mandatory redemption rights (rare)- company has right to buy shares at any time and shareholders can sell at any time.
* Problems with a restriction:
  + What is fair market value?
  + How can fair market value be proven
  + Does it include an illiquidity discount
  + Does an event even trigger the buy-out transfer?
* MBC Approach:
  + Restrictions and buyourt agreements are permissible if:
    - Existence noted conspicuously on the stock certificate (aka “legend certificate”)
    - Must have a reasonable purpose
* Restrictions and buyouts are often seen together.
* can be in the charter, bylaws or agreement.
* RMBCA- Restrictions and buyout agreements are permissible if:
  + Existence noted conspicuously on the stock certificate- legend certificate
  + Must have a reasonable purpose

1. Buyout Agreements:

* The purpose of a buyout agreement is to provide a market for shares when a shareholder dies or wants to exit the corporation.
  + Applies in closely held corporation
* The agreements allow shareholders to exit the company and be compensated for their shares.
* The agreement may be structured where the corporation is the purchaser.
* For silicon valley, the major restriction and buyout agreement is the vesting of shares.
* There is often a right of first refusal.
  + The benefit of the right of first refusal is that this avoids having to value the shares- that is done by the third-party offer.
* Problems with Buyout Agreements:
  + Valuation- there is no market for private company stock making it difficult to value
  + The longer the passage of time the more likely a buyout
  + A formula may favor one party over another.
* Three of the more common ways to value a business are as follows:

1. Book Value:

* Based on a company’s balance sheet and is equated with net worth or equity in the business. The value remaining after liabilities are subtracted from assets.
* Financial statements may not represent the current value and does not reflect goodwill value or the company’s earnings potentials.

1. Liquidation Value:

* The net amount remaining after a business is brought to an end, its assets are sold individually, and its creditors are paid.
* Hard to calculate if assets are part of a larger project.

1. Company cash flow or earnings:

* Most popular
* Based on projections of what its earnings or cash flow is likely to be in the future

1. Cases:
2. Hanewald v. Bryan’s Inc (par value and liability)
3. Facts: After Bryans went out of business for failure to pay a promissory note on a lease, Hanewalk filed suit against cororation and Bryan family members to whom the corporate stock had been issued. seeking to hold them personally liable.
4. Rule: A shareholder is liable to corporate creditors to the extent is stock has not been paid for. Shareholders must pay par value in par value states.
5. Holding/Notes: A corporation that issues stcok as a gratuity commits fraud upon creditors.
6. Obre v. Alban Tractor Co. (thin incorporation/caitalization)
7. Facts: Obre, president of Annel corporation, was issued an unsecured note by the corporation that was represented to be a contribution to the capital of the corporation and not a bona fide debt owed to Obre upon which he could share as a general creditor.
8. Rule: Where a corporate plan is adopted and pursued in good faith and in accordance with the laws of the state, those dealing with the corporation have only themselves to blame if they neglect to seek information obtainable from public records and other available sources.
9. Fett Roofing and Sheet metal Co. v. Moore: (thin incorporation and caitalization)
10. Facts: The bankruptcy judge concluded that the advances made to Fett Roofing, by Fett, the sole stockholder, were actually contributions to capital and not loans.
11. Rule: If inide creditors have deliberately undercapitalized the corporation in the beginning, or subsequently looted the corporation’s capital or otherwise tried to gain an unfair advantage against outside creditors, the bankruptcy court may equitably subordinate their claims.
12. Holding/Notes:
13. Katzowitz v. Sidler (pre-emptive rights)
14. Two of three directors of c close corporation voted an additional issuance of stock which they opted to purchase and which the third director refused. When the corporate assets are sold, the proceeds were distributed in proportion to the stock owned, and the third director sought to have the distribution set aside.
15. Rule: Where new shares are offered in a close corporation, existing shareholders who do not want to or are unable to purchase their shares of the issuance are not estopped from bringing an action based on fraudulent dilution of their interest where the price for the shares was inadequate.
16. Holding/Notes: The concept of pre-emptive rights rights was fshioned by the courts to protect against dilution of shareholders interest and isespecially applicable to a close corporation. The issuing the stock below fair value diluted the third owners’ shares.
17. Denkins v. Zinkan Enterprises (buyout agreements)
18. Facts: Denkins sued for breach of contract when Zinkan failed to repurchase its stock pursuant to Denkins exercise of a “put” option.
19. Rule: A trial court’s decision will be overruled if it is so manifestly contrary to the natural and reasonable inferences to be drawn from the evidence as to produce a result in complete violation of substantial justice.
20. Holding/Notes: There was insufficient evidence to support plaintiff’s claim theory that the book value for his put option should be calculated using the same method prescribed for his stock purchase option. Plaintiff has obligation of proving a valuation.
21. Organizing the Corporation:
22. Beginning to Incorporate: (Why is it important to organize the corporation?)

* Incorporation and organization are not synonymous and are two separate events in the life of a corporation
  + Incorporation- when the state issues the corporate charter
  + Organization- refers to the development of the bylaws and the creation and appointment of shareholder, officers, and directors.
* Corporation may have to hold a meeting after incorporating- written consent permitted
  + The default rule is that written consent must be unanimous
* Demonstrates separateness
  + If corporation and owners do not have separateness, difficult to value assets.
  + Record keping demonstrates separateness.
* Allows corporation to keep good records
* Steps in organizing:
  + File Articles
  + Action by incorporator
    - Incorporator is in charge before the directors.
  + Adopt bylaws
  + First Directors meeting
    - Directors are the brains of the company
    - Directors appoint officers.
    - CA, corporation must declare who is president and CEO
  + Sale of stock
    - Directors must authorize the sale of stock
    - If consideration for stock is other than cash, the director must put a dollar value on the consideration.
  + Appoint Officers
  + Adopt any action of promoters
    - Corporation may ratify contracts or reimburse promoters
  + Compensation of directors and officers
  + Qualification to do business:
    - Domestic coproation- conducts business in the state where it is incorporated
    - Foreign corporation- doing business in one or more states that are not the state of incorporation
    - Corporations wishing to do business in other states must qualify to do business.

1. Important Steps and Processes:
2. First Director’s Meeting:

* DE- the types of officers a corporation has are provided in the bylaws.
* See slides class twelve for CA

1. Minutes:

* Requirements:
  + RMBCA:
    - A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting.
    - A corporation shall maintain its minutes in written form.
  + CA Requirement (See Class Slide 12)
    - Each corporation shall keep adequate and correct books and records of account and shall keep minutes of the proceedings of its shareholders, board and committees of the board and shall keep at its principal executive office, or at the office of its transfer agent or registrar, a record of its shareholders, giving the names and addresses of all shareholders and the number and class of shares held by each. Those minutes and other books and records shall be kept either in written form or in another form capable of being converted into clearly legible tangible form or in any combination of the foregoing.
* Minutes have evidentiary requirements.
  + Minutes are discoverable in litigation.

1. Corporate Hierarchy of Authority:
2. Legal Authority:
3. Law-corporate statute

* Statute is binding authority.
* Bylaws must be consistent with charter and statute

1. Charter
2. Bylaws
3. Board of directors (board resolutions)
4. Bylaws:

* The adoption of bylaws is the first step in organizing the corporation.
* Bylaws may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation
* If a particular bylaw provision is ineffective, a court may decide to interpret the bylaw as a contract between the persons who agreed to do it.
* Only applied in a closely held corporation
* Bylaws provide for how directors will be elected if not specified in the charter
* RMBCA: Bylaws may contain any provision for managing the corporation that is not inconsistent with the law or articles of incorporation.
  + “Aa corporate powers shall be exercised by… and the business...of the corporation managed by...its board of directors, subject to any limitation set forth in the artilces of incorporation
* Govern the internal workings of the corporation and provide details on many items
* Either board or shareholder can amend bylaws- easier to amend bylaws than charter
  + If flexibility is desired, better to have the provision in the bylaws.
  + Charter amendments require both board and shareholder approval
* DE Section 228 (see class notes 12)
* (Paulek) The articles of incorporation control over the bylaws.
* Proxy materials- materials that are distributed to the sahreholders.

1. Deadlock and Quorum:

* Deadlocks can be created by high quorum requirements
* Be wary of veto rights.
* Dissolution is usually not desired.
* Quorum requirement- number of shareholders or directors required to have a valid meeting.
* (Roach)- a super majority must be set forth in the charter
* Default rule- shareholder agreements can be made by majority.

1. Cases:
2. Roach v. Bynum: (bylaws and deadlock)
3. Facts: two directors sought dissolution of the corporation due to a deadlock, which was the result of the third director’s blocking the corporation action.
4. Rule: When a corporation’s statute commands that a provision which governs shareholders rights be set out in the Certificate of Incorporation, but the provision is not so set out, a bylaw that purports to regulate the same subject is void.
5. Datapoint v. Plaza Securities: ( bylaws, deadlocks, and quorums)
6. Facts: The directors of plaza securities enacted a bylaw effectively blocking the corporate action to which the shareholders had consented.
7. Rule: A bylaw designed to limit the taking of corporate action by shareholder consent is invalid.
8. Paulek v. Isgar: (articles of incorporation and bylaws)
9. Facts: There was a conflict between the articles of incorporation and the bylaws.
10. Rule: Where bylaws conflict with the articles of incorporation, the articles of incorporation control, and the bylaws in conflict are void.
11. Jones v. Wallace (bylaws and articles of incorporation)
12. Facts: When Wallace was the sole shareholder the directors adopted a bylaw which called for a 100% quorum requirement, even though this requirement was not included in the articles of incorporation as required by the Oregon Business Corporation Act.
13. Rule: Under the Oregon Business corporation Act, bylaws are limited to provisions for the regulation and management of the affairs of the corporation and inconsistent with the law or articles of incorporation.

1. Corporate Authority:

* Powers must derive from the bylaws or a corporate resolution.
* When in doubt get a secretary’s certificate attesting to authority
* Focus on whether the decision was ratified.

1. Shareholders:

* General rule- shareholders have no power to manage the corporation.
  + Shareholders only have powers granted to them by statute.
* In closely held corporations, shareholders may take a more active role.
  + MA permits shareholders to assume some or all of the power of the board of directors.
* No rights to directly control the day to day management of the corporation.
* RMBCA allows shareholders to enter into agreements concerning management of the corporation.
* The most important power of shareholders is to elect directors- greatest power
* The authority of shareholders is indirect:
  + Elect and remove directors, with or without cause
  + Fill vacancies on the board (so can other directors)
  + Request information
  + Modify bylaws
  + Approve fundamental corporate change
* Exception: Securities law allow shareholders of public companies to initiate precatory resolutions for a shareholder vote (federal corporate law)
* Exception: New federal law for public companies- allow certain shareholders access to proxy to propose their own directors for elections and “say on pay”
* Exception- institutional ownership of pulicly held corporations allow certain large owners to get the attention of management- this is influence though and not management.

1. Who is a shareholder:

* Shareholders of closely held corporations are typically individuals for whom the corporation is both an investment and source of livelihood.
* Shareholders could be corporations or other entities.
* For public companies, stock is now usually held by institutional investors.
* There is a difference between a beneficial owner and record owner
* Sometimes a shareholder may not own the share but have voting rights

1. When and How to shareholders act:

* Shareholders act at a meeting or by written consent
* Laws and bylaws specify quorum and notice requirements and meeting pocedures.
* Shareholders have inspection rights and rights to see the books and records of the corporation for certain shareholders

1. When acting by written consent:

* The default rule is unanimity when acting by written consent
* No quorum concept when acting by written consent
* Model Act requires unanimity unless the charter provides otherwise
* DE mandates just majority approval
* CA has just majority approval- sometimes of each class of stock- except director elections by consent must be unanimous
* For written consents, a true majority must be obtained.
* At meetings a majority of the quorum is sufficient.

1. Director Elections:

* Directors are elected by a plurality, unless otherwise provided in the charter.
  + Director with the most votes wins even if having not achieved a majority of the votes.
  + The plurality prevents failed elections
    - Failed elections- when positions are left vacant because a majority or a super majority is required and the correct number of votes are not received.
  + Holdover rule- director continues to serve until a succesor is elected.
* Voting in uncontested elections has always been either “for” or “withold vote”
* Directors are usually re-elected because there is no vote against a director- i.e. to remove the director and leave the seat empty.
* DE adopted an optional mechanism to require majority approval for directors.
* The MA offers an alternative voting mechanism to provide for votes against a director.
  + MA provides for different regimes for public and private companies.
* DE continues to use the basic default rule of plurality voting, although it allows for alternatives if stated in the charter.
  + CA is similar.
* Shareholders can vote for a candidate or withhold their votes in protest.
* Ballot and Proxy Access:
  + Historically, just the corporation could use the corporation’s proxy statement to nominate directors for election.
  + Now, under Dodd-Frank- a DE if elected to it all public corporations are required to permit proxy access- SEC’s implementation rules were thrown out last year.
  + As a general rule, a corporation’s incumbent board nominates directors for elections and presents the nominations.
  + DE and MA permit corporations permit shareholders to access the proxy materials for director elections.
* Attendance At Meetings:
  + Shareholders are entitled to vote or to appoint a substitute a proxy to vote for them.
  + There are rules for the duration and revocability of proxies.
  + Proxies are generally requested (solicited) by the corporation for a meeting to insure that the meeting will have a quorum for the conduct of business, but proxies may be solicited by someone wanting to gain influence of the board.
* Shareholders can remove directors with or without cause.

1. Shareholder Rights (Inspections)

* CA is friendly to minority shareholders.
* Shareholders are entitled to vote.
  + For voting purposes, the registered owner of the shares is usually considered the owner.
* Two kinds of inspection rights:
  + Right to inspect the shareholder list
    - RMBCA: Proper purpose not required.
    - DE: proper purpose germane to the meeting
    - CA: generally no proper purpose test
  + Right to inspect the books and records.
    - RMBCA: Basis records can be inspected without a proper purpose
    - DE: any proper purpose
    - CA: purpose reasonably related to such holder’s interests as a shareholder
* (Seinfeld) Proper purpose requires showing “some evidence” to suggest a “credible basis” for a court to infer waste, mismanagement, etc.
  + Court says that this is the lowest possible burden
* When approaching a shareholder inspection question:
  + Determine what is being requested.
  + Corporation does not have to provide material and may only need to be made available.
* The documents only need to be available and they do not have to be provided.

iv. Calling a Meeting and Voting:

* Usually a special meeting can only be called by the board of directors.
  + CA allows a minority shareholder to call a special meeting.
* Meetings are usually held annually.
* Shareholder powers are exercised at shareholder meetings.
* Shareholders must be given notice of the meeting.
* For a meeting to be properly convened, a quorum must be be present.
* Shareholders can vote by proxy or in person or by electronic means
* Fundamental corporate changes require approval.
* Voting group- comprised of one or more classes of shares authorized to vote and to be counted collectively on a matter.

1. Directors (Authority)

* In a general corporation, the board of directors, only while acting collectively, have oversight responsibility for managing the corporation.
  + General rule- no individual authority
* MA (general rule)- all corporate power shall be exercised by the board of directors and the business and affairs of the corporation shall be managed under the direction and subject to the oversight of the board of directors.
* The directors do not get their power from the shareholders- power from corporate statute

1. Overview/ How many directors does a corporation need:

* Directors serve as a source of advice and outside counsel, offer discipline value, and act in crisis situations.
* Only natural Americans can be directors of a board.
  + In America, directors must be human- not an entity
* Directors elect senior management.
* Directors can serve in an advisory or management role.
* Generally, a person may not hold the title of president and secretary
* DE and MA- there must be at least one director.
* CA- one if the corporation has one shareholder, and two if the corporation has at least two shareholders and three or more if the corporation has three or more shareholders.
* There can be vacancies.
* A quorum is based on the number of authorized director positions, not the actual number of directors, unless the bylaws provide otherwise.

1. Authority:
   * Directors manage the business and affairs of the corporation
   * The director powers and authority is collective and directors do not have any power as individuals.
   * Directors may amend the bylaws, unless otherwise specified.
   * Directors cannot allow a proxy to attend a meeting.
   * DE and CA- no provision for limiting director power by private agreement (other than close corporations). There is a provision for limiting powers in the charter.
   * RMBCA- Text Page 352
   * See Statutes slides 14 if in a bind (Summary:
     + The business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board.
     + DE- The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as otherwise provided in this chapter or in its certificates of incorporation
   * Directors have no individual power- cannot sign contracts as directors
   * The power is derived as a collective
   * Committees are okay
     + Public companies must have certain committees
   * Director functions are personal- cannot have an entity as a director
   * Exception: directors may act through committees that have been established.
2. Director Procedure for Action:

* Procedures set out in the bylaws
  + Bylaws specify notice and quorum requirements
* By meeting, after notice of time and place- with minimum quorum for meeting met
* Action without a meeting requires unanimity of the board, and must e in writing (action by written consent)
* Directors can meet by conference call or through electrnic means
* A quorum of directors is based on the number of authorized director positions, not the actual number of acting directors, unless bylaws provide otherwise.
* Committees:
  + Only directors can be on a committee
  + CA- must have two members on a committee.

1. Officers (Authority)

* Officers are agents of the corporation, not of the shareholders
* Officers are agents of the board of directors acting collectively as the corporation, not of the shareholders.
* Statutes specify the responsibilities.
* The board appoints the officers.
  + Exception: RMBCA permits the board to allow an officer to appoint an officer.
* CA requires a chief executive officer, a secretary and CFO
  + Can be the same person
* DE and RMBCA do not require any specific officers, although one must record minutes of meeting and maintain the books
* Agency Principles- officer is given powers that go with the office, unless the board or bylaws says otherwise
* Statutes are generally enabling, and state that the powers in the bylaws or by board election
* Powers are given by course of conduct or acquiescence
* Agency authority doctrines that apply- implied, incidental, and apparent
  + Incidental authority- the authority to perform acts that are incidental to acts for which the officer has actual authority.
* Officers also have implied and apparent authority
  + Authority- if not actual or express- can arise from agency doctrines
  + Authority may also be imputed by estoppel

1. President (Authority)

* The general rule (Molasky) for a president’s implied authority is that the president has the power to bind the corporation in the usual course of business.
* President has the power to hire an attorney to protect the corporation.
* No authorization of the corporation to guarantee the personal obligation (Molasky)
* President has the inherent power for matters in the ordinary course of business.
* (Elblum)- President can defend and institute litigation to preserve corporate assets.
  + President does not have the authority to file a chapter 11 case
    - Bankruptcy code requires board approval
* (Bresnahan)- Discusses rogue officers.
* For matters outside usual course of business, the president’s authority to act must be granted by a state statute, the charter, or bylaws, a resolution, or ratification.

1. Chairman of the Board:

* If questioned on Citigroup- see clides class 14
* Courts may honor contracts entered into by the Chair
* CA- the chairman has the same authority as the president
  + CA treats chairman as the senior most officer
* Chairman has authority to engage in ordinary course of business

1. Vice President:

* The vice president’s one inherent power is to serve in the place of the president when the president is absent or incapacitated.
* Has one inherent power- signing for the president when the president is not available.

1. Corporate Secretary:

* Power related solely to internal affairs (not business)- function is to keep minutes and other non-financial records and to certify them.
* Secretary cannot transact business on behalf of the corporation
* Keeping minutes and certifying records are most important functions.
* The custodian of records.
* Secretary can certify the corporation is acting with authority.

1. Treasurer:

* Treasurers are responsible for the receipt and disbursement of company funds, company loans and repayment, investing funds, and monitoring the budget.
* Power is internal as well.
* The custodian of corporate funds.
* Has an implied power over financial matters.
* Absent authority- the president cannot bind the corporation or conduct business.
* CFO:
  + The CFO may be able to bind the company up to a certain dollar amount.
  + CFO has discretionary decision making authority.
    - Treasurer is only ministerial
  + Bylaws grant authority.

1. Other Officers:

* VP of Departments- clothed with at least apparent authority to speak on certain issues.

1. Cases:
2. Gashwiler v. Willis: ( shareholder and director authority)
3. Facts: The shareholders of the corporation voted to sell the corporation’s assets but defendant objected to the introduction of the deed into evidence because it did not appear to be the act or deed of the corporation.
4. Rule: The power to sell and convey property can only be conferred to corporate trustees when assembled and acting as a board.
5. Holding/Notes; Shareholders possess no authority to act on behalf of the corporation Shareholders can , however, elect, nominate, and remove directors.
6. Seinfeld v. Verizon Communications, Inc. (shareholders rights/proper purpose)
7. Facts: Seinfeld claimed that his desire to inspect the corporate books and records did not need to be supported by evidence.
8. Rule: A shareholder’s request to inspect a corporation’s books and records for the purpose of investigating mismanagement, waste, or wrongdoing will be denied where the shareholder presents no evidence suggesting a credible basis from which a court can infer that such mismanagement, waste or wrongdoing may have occurred.
9. Manson v. Curtis: (authority of directors)
10. Facts: Curtis allegedly breached an agreement with Manson conditioned on manson controlling the board of directors of a corporation in which each was a shareholder.
11. Rule: The board of directors, rather than shareholders, is vested with full power and responsibility to manage the corporation.
12. Notes/Holding: The affairs of every corporation must be managed by the board of directors subject to the valid bylaws adopted by the shareholders. Shareholders cannot confer or revoke the powers of the board of directors.
13. Molasky Enterprises Inc. v. Carps Inc. (President authority)
14. Facts: Molasky Enterprises was the guarantor of a personal loan of Carp, but Carp claimed that the president endorsement of the note was not effective because the board of directors did not approve.
15. Rule: A corporate officer cannot bind a corporation on his personal obligation absent the board’s approval.
16. Holding/Notes:
17. General Overseas Films v. Robin International: (treasurer authority)
18. Facts: Plaintiff contended that treasurer could bind the company to an unauthorized loan guarantee on the basis of apparent authority.
19. Rule: A corporate treasurer cannot bind a corporation to a loan guarantee outside of normal type of business where the facts indicate that the treasurer has neither actual or apparent authority to do so.
20. Controlling the Corporation:

* The best time to implement controlling procedures is at the beginning of the corporation.
* Control is most important in a closely held corporation
* Directors are elected by a plurality of votes

1. Voting:

* The higher the voting requirement, the more power the minority has.
* Corporate statutes provide that directors are elected by a plurality of votes, not a majority
  + Currently the subject of debate
* Most state statutes require straight voting- a shareholders gets to vote the shareholder’s shares for each director seat open
* Cumulative Voting:
  + Favors minority interest
  + Shareholders are allowed votes based on the number of shares and can allocate those shares how they please.
  + CA- cumulative voting can be invoked by any shareholder at any election of directors
    - Can be removed upon corporation being taken public
  + DE and RMBCA- no cumulative voting unless provided in articles
  + Some states- cumulative voting required but can opt-out in articles.
  + A shareholder has the number of votes equal to the number of shares multiplied by the number of directors being elected AND
  + The shareholder can cast all of those votes for any director.
  + Cumulative voting is also used in removal
* Straight Voting:
  + Each share gets one vote and those shares are votes for each director seat that is open.
    - Shares are voted in blocks.
  + Votes are not accumulated and cannot all be cast for one director.
  + Result- majority shareholders can elect all directors.
  + Straight voting allows the majority to elect all of the directors.
* Directors elected cumulatively can only be removed cumulatively
* Staggering the board is permitted and deters a takeover
  + If used in cumulative voting, this favors the majority.
* Cass voting is permitted if provided in the charter (used in venture financings)
  + Class voting can empower minority interests
* Weighted voting- each share does not count as one vote- this is acceptable
  + Usually only in rare companies with rare qualities.
* Corporations can also provide for higher voting majority requirements subject to state limitations.
* Contingent voting- provided to preferred shareholders or even debt holders
  + Example- failure to pay a dividend when agreed results in the preferred stock having the right to elect three directors.
  + If an event happens, votes will be allocated to a person or for a decision.

1. Removal of Directors:

* The fewer the number of directors, the less of a chance the minority interest can elect a shareholder.
* Some statutes allow for the removal of directors with or without cause.
* Modern statutes (except NY)- directors can be removed with or without cause at any meeting called for that purpose.
  + Some states do not allow this to be changed.
* Older states were silent or provided for only for cause removal
* NY- if not altered in charter or bylaws, directors can only be removed for cause
* Cause: Not readily defined
  + DE- any director can be removed with or without cause by the holders of a majority of the shares that entitled them to vote
  + CA- any or all directors may be removed without cause if the removal is approved by the outstanding shares.

1. Filling Vacancies:

* CA- vacancies (other than those created by removal of a director) can be filled by the board. if less than a quorum, directors can fll vacancies by written consent at a meeting.
  + Charter/bylaws can allow board to fill vacancies created by removal.
* Shareholders can fill vacancies not filled by the board.
* DE: directors can fill vacancies (see slides class 14 if in a bind)
* The board may act simply by not filling a vacancy
* If both directors and shareholders want to fill the vacancy, usually its the first party to fill the vacancy.

1. Deadlock:

* Deadlock injures closely held shareholders because there is no market for their stock.
* Either shareholder or director level deadlock can paralyze the corporation
  + Can occur at either director or shareholder level.
* Remedies available:
  + Appointment of provisional director
  + Dissolution of the corporate entity

1. Governance: Oppression and Dissent

* Majority shareholder fiduciary duty- treat the minority with utmost fairness meaning:
  + Equal opportunity in liquidity (Massachusetts jurisdiction- Rodd case)
  + Satisfy minority’s reasonable expectations (NY Jurisdiction- Kemp and Beatley)
  + DE- Valid business reasons can support unequal but fair treatment (Nixon case)
* Dissension can arise when one class or group works to the financial disadvantage of another.
  + Arises when the majority is using the assets of the corporation for the benefit of themselves and the minority does not have this opportunity.
* CA Oppression: persistent and pervasive fraud; mismanagement or abuse of authority; persistent unfairness toward any shareholders; corporation’s property being misapplied or wasted.
* Closely held corporations have the problem of liquidity, and the lack of marketability which means the minority cannot easily escape the majority oppression.
* The general rules: (1) decision making by the board; (2) the election of the board by a majority or shareholders, and (3) majority decision making by the board does not always function perfectly for minority shareholders in closely held corporations.
* Closely held corporations have the problem oppression and dissent
  + Arises because of a failure of governance mechanisms or
  + Arises because parties expectations are frustrated
    - A party is taking advantage of its control position or
    - A new party replaced original party, changing the previous unstated understandings on control..
* Minority Duty to Majority:
  + In transferring shares, minority shareholders owe fiduciary duties to majority to preserve the certain status of the corporation- example “S” status.
  + Minority shareholders cannot transfer shares in such a way that a corporation loses its status- example “S” corporation

1. Tests for Oppression and Dissent:

* Jurisdiction is important- rules are jurisdiction specific.

1. Equality of opportunity:

* Equality of opportunity for stock repurchases for closely held corporations
* Meinhard duties of majority to minority in management of corporation (not with regard to rights inherent in owning stock)
* (Footnote 18)- The fiduciary duty only applies to the operations of the enterprise and the court does not comment on transactions when the corporation is not a party.
  + In the same jurisdiction MA- the court holds that a valid business purpose would be grounds for an exception.
* When the majority is in control, there must be an equal opportunity for liquidity.

1. CA’s No New Causes of Action:

* Bauer- cannot re-write the statute or find new causes of action.
* CA does not appliy reasonable expectations or equal treatment concepts
* Statutory causes of action must be proven (fraud, mismanagement, etc)

1. Reasonable Expectations:

* This test is highly fact specific.
* In reasonable expectation jurisdictions- put minority shareholder in position she would have been in had there been no wrongdoing
  + Not provide a windfall or a penalty
  + Remedy must be proportional to breach.
* Reasonable expectations- an objective test evauated as of the time when shareholders commit their capital to the enterprise
  + Other states have assessed reasonable expectations by examining entire history of participation in the enterprise.

1. Freedom to Contract (DE)

* Fair does not mean equal
* If the corporation has a reasonable basis for acting and it doesn’t appear to be unfair, this will survive and need not be offered to minority shareholders.

1. Remedies for Oppression:

* (RMBCA)- dissolution is authorized if directiors have acted in an opporessive conduct
  + Permits a buyout
  + Leaves the definition of oppression up to the courts.
* A share transfer agreement could govern the price at which share must be purchased.
* Dissolution cases often raise fair value issues.
* DE: you make your bed, you lie in it.
  + Freedom of contract focus- fair does not mean equal
* Court reviewed entire fairness of transactions
* DE does not have an equivalent oppression statute

1. Freeze-Outs:

* Denying the minority any participation in management, inspection rights and economic value in shares.
* Freeze outs are based on specific facts and circumstances.

1. Tools to Avoid Oppression:

* Stautory and Contractual provisions:
  + state corporate statutes usually address the issues of oppression, deadlock, and dissension in one of two ways:
    - Model Act Approach- General corporation statutes may either include special provisions for closely held corporations through general corporate code
    - DE- may contain a separate unit of code applicable to the closely held corporation

1. Voting Mechanisms:

* Voting mechanism are a solution: Indirect mechanism
  + An indirect way of dealing with majority control and may not be best solution
  + Voting mechanisms control management indirectly through shareholder voting mechanisms that depart from the majority voting rule
  + Corporations can elect to be a close corporation and agree to run th corporation by a written agreement rather than a board.
  + Different voting mechanisms are not always better.
* Board representation alone may not be enough.

1. Strategy Responses: Dissolution:

* Dissolution is not favored by the courts and is a worst case scenario.
* MA requires that a proposal for dissolution must be recommended by the boad of directors and approved by shareholders.
  + Then file artiles and liquidate
* Shareholders may initiate dissolution if the directors and shareholders are deadlocked and this cannot be broken or if the directors have acted in an illegal or fraudulent way or if assets are besing wasted.
* In general the statutes are blunt approaches: Dissolution Remedies:
  + Voluntary dissolution
    - Shareholders petition for court ordered dissolution (must own a sufficient number of shares)
  + Secretary of state action- secretary of state can dissolve corporation- if corporate is delinquent in paying franchise fees
  + Attorney general action for criminal matters
  + Creditor action
  + Shareholders in closely held corporations may agree to dissolution if certain events occur.
* Provisional directors can be appointed in the event of a deadlock
  + Allowed in MA jurisdictions and DE
* Mandatory buyouts are options- this increases instability
  + Allowed in MA
  + In closely held corporations, shareholders can elect to purchase the shares of the shareholder petitioning for dissolution

1. Statutory Responses: Statutory Responses:

* See Page 437-428 of textbook for MA approaches to remedy oppression, dissent, and deadlock.

1. Avoiding Deadlock:

* Voting and buyout agreements are the most common ways to deal with oppression in the front end.
* Deadlock can be avoided through agreements and contractual provisions including:

1. Arbitration and appraisal
   * May be used as a litigation substitute
   * Arbitration may be used as an appraisal procedure to determine the fair value of closely held corporation
2. Voting agreements- common in venture financing
3. Shotgun remedies for stock purposes- remedy that provides one of the parties will buy the other out and whoever agrees is the buyer/seller.
4. Types of Voting Agreements:
5. Voting trusts- shares contributed to a trust; a trustee votes the shares rather than the shareholders

* Trusts are generally limited to ten years.
  + Agreements have no duration.
* Frmed in ordinary way under trust law
* The trust is granted legal title to the shares and the trsutee then votes based on the terms of the trust.
* Voting trusts can still receive dividends ad inspect books.
* Creditors can also act as a trustee and control the trust until the loan is repaid.

1. Pooling Agreements:

* The drafters attempt to secure the unity of a voting trust while allowing shareholders control over their own shares.

1. Proxies:

* Irrevocable proxies- these are agencies for a particular purpose. Corporate statute set terms.
* Revocable proxies- usually for specific meetings- not for long-term deadlock planning

1. Voting agreements to vote a certain way.

* Shareholder agreements do not have to be disclosed unless they are material under securities laws.
* Cannot be enforced absent a written agreement.
* The general rule is that shareholders may vote their shares anyway they wish.
* Agreements among shareholders contain provisions governing anything the shareholders wish so long as the agreement does not constitute an illegal voting trust or violates public policy.
* See slides 12 and 13 of Class 17 for CA statutory language on voting agreements in close corporations.
* New CA statute allows for voting agreements in any corporation.
* The form of the agreement is important.
* Extent of agreements:
  + The general rule is that shareholders can control the discretion of board members.
  + Agreements can cover anything not in violation of law.
  + Problems arise when agreements try to control operational matters- agreeing how a director will vote or allowing shareholders to appoint officers.
  + MA is permissive
  + The trend is to uphold thse types of agreements (those controlling the operations) in closely held corporations even though they have not elected “close” corporation status
  + RMBCA- allows for flexibility
    - Essentially close corporation flexibility for closely-held corporations without having to elect close corporation status
  + DE Section 141(a): The business and affairs...shall be managed by or under the direction of a board of directors, except as may be otherwise provided...in its certificate of incorporation.

1. Employment Contracts:

* Severance of employees provides specific payment in the event of termination- this can protect a minority shareholder
* Directors can terminate officers’ employment
* Change of control protection is common
* The employment contract is a contractual agreement that can be used to distribute corporate control.
* Specific performance is not a remedy available to an officer if the corporation breaks the officers employment contract.
* Golden parachute contracts- apply when there I a change of control and an executive is either discharged without cause or is subject to a significant change in duties. The executive is entitled to compensation and bonuses.

1. Cases:
2. Campbell v. Loews (removing directors)
3. Facts: President of L sent notice calling stockholders meeting for the purpose of filling board vacancies, enlarging the directorate, and ousting two directors from a rival faction. Plaintiff brought suit to enjoin the meeting.
4. Rule:

* Shareholders have the power between annual meetings to elect directors or to fill newly created directorships.
* Shareholders have the power to remove directors for cause
* Shareholders have the power to remove directors for cause where the corporation has cumulative voting
* Shareholders may remove a director for cause only after that director has been given adequate notice of the charges of impropriety against him and an opportunity to be heard
* A charge against a director of engaging in a planned scheme of harassment constitutes cause for removing the director as a matter of law.

1. Hall v. Hall: (deadlock)
2. Facts: Ed Hall sought to enjoin Harry Hall from refiusing to attend shareholders meetings, to enjoin individual defendants from establishing a terminal date for exercise of pre-emptive purchase rights for the new issue and to continuing to act as directors and officers.
3. Rule: Since participating by a shareholder in management of corporate affairs is voluntary, it necessarily follows that no shareholder may be compelled to attend or participate in shareholders meetings.
4. Donahue v. Rodd Electroype (oppression and equal opportunity)
5. Facts: A minority shareholder in Rodd complained that she was not offered the same deal to resell her shares to the corporation as a majority shareholder in the close corporation was ofered
6. Rule: When a close corporation repurchases stock from a member of the controlling group, it must offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price
7. Notes; Close corporations resemble a partnership.
8. Brodie v. Jordan: (oppression and freeze outs)
9. Facts: Plaintiff had been frozen out by defendants and defendants contended that plaintiff was not entitled to a buyout of her shares.
10. Rule: A forced buyout is an inappropriate remedy for the freeze-out of a minority shareholder in a close corporation where such a remedy effectively grants the minority the windfall or excessively penalizes the majority.
11. Notes; the appropriate remedy was to restore the frozen out shareholder to those benefits which she reasonably expected.
12. In re Kemp v. Beatley (oppression and dissolution)
13. Facts: Plaintiff contended that the corporation’s refusal to make distributions to him in contrast to prior policy constituted oppressiveness justifying dissolution.
14. Rule: Actions by the majority shareholders to restrict distributions to the prejudice of minority shareholders may constitute oppression and justify dissolution.
15. Notes: Dissolution will usually only be ordered in selective cases and under extraordinary circumstances.
16. Nixon v. Blackwell (DE oppression)
17. Facts: Shareholders of a class of corporate stock contended that directors breached their fiduciary obligations by offering certain liquidity devices to corporate employees but not to minority shareholders.
18. Rule: When corporate directors are on both sides of a transaction, they have the burden of establishing the transaction’s “entire fairness,” sufficient to pass the test of careful scrutiny by the courts.
19. Notes: Fair does not have to mean equal and directors are not obligated to offer the same liquidity devices to each class of stockholders. Corporations are free to create different classes of stock.
20. Ramos v. Estrada: (voting agreements and deadlock)
21. Facts: Defendant Estrada signed a shareholder voting agreement and later contended that because the corporation was not a close corporation the agreement was not enforceable. The shareholders had to vote a certain way otherwise failure to do do constituted election to have shares reurchased.
22. Rule: A corporate shareholder voting agreement may be valid even though the corporation is not technically a close corporation.
23. Holding/Facts: Agreements to vote shares are commonly called shareholder vote pooling agreements.
24. Lehrman v. Cohen: (voting trusts and shareholder agreements)
25. Facts: There was a dispute between rival factions over issuance of class AD stock and its voting power.
26. Rule: The creation of new class of voting stock does not divest and separate the voting rights, which remain vested in the stockholders who created it, from he other attributes of the ownership of that stock.
27. Holding/Notes: To be upheld, a voting trust or pooling agreement must be created for a legitimate purpose. A voting trust will not be upheld where it is established to gain control over the minority.
28. Piercing the Corporate Veil:
29. Introduction and Basic Guidelines:

* Shareholders liability for corporate obligations is limited to the amount which they contributed to the corproation in exchange for their equity interest.
* Exceptions to limited liabilty in corporations:
  + The full subscription for shares must be paid or shareholder may be required to make up the difference.
  + Promoters contracts.
* Limited liability means that creditors of the corporation cannot reach the assets of the shareholders.
* A cororation shall be considered a separate entity until there is sufficient reason to the contrary.
* Piercing is judge made law.
  + Piercing is not built into the corporate statutes.
  + Some states- TX and NV- have added piercing to their corporate statutes.
* Piecing is sought because the corporation does not have enough assets to satisfy the judgment
  + Plaintiff is searching for deep pockets
* Doctrine is invoked frequently.
* Sophisticated creditors ca protect themselves from the limited liability of their debtors but most small contract creditors cannot.
* Tort creditors cannot protect themselves
* Parties can assess risks in doing business with corporations and can price products and services accordingly.
* Fraud does not allow risks to be properly evaluated.
  + Courts should pierce when fraud is present.
* Piercing may give large corporations an advantage over small corporations because large corporations will never be pierced.
* State law legislative trends are to further extend limited liability.

1. Proving Liability:

* Plaintiff must first prove corporation is liable
* Undercapitalization:
  + Undercapitalization creates an inference of inequitable conduct
  + CA- undercapitalization is a factor but not determinative of the unity of interest prong of a two-part test
  + Allegations of undercapitalization are more likely to succeed in litigation.
  + The parent business must adequately capitalize a subsidiary
  + The creation of an undercapitalized subsidiary justifies an inference that the parent is either deliberately or recklessly creating a business that will not be able to pay its bills or satisfy judgments against it.
  + A corporation may be undercapitalized in an accounting sense but correctly capitalized if it has correctly purchased insurance and for the proper limits.
  + Undercapitalization is one factor but not determinative in piercing.
* What do Court’s Consider Important:
  + Observing corporate formalities
  + Assumption of risk may be a defense in certain circumstances- where a credit investigation or where credit risk is obvious.
* Certain states require actual fraud to pierce the veil.
  + DE requires actual fraud
* Piercing the LLC: Fewer formalities
  + Some states have similar piercing requirements for the LLC.
* Statutory Piercing:
  + Statutes sometimes hold control persons liable for corporate acts.
  + The use of a subsidiary does not by itself create liability for the parent
  + Regular piercing doctrines may apply
  + Parent may actually be the actor in which case there may be liability- this is not a piercing concept
  + The veil may be pierced when the corporate form may be misused to accomplish certain wrongful acts on the shareholder’s behalf.
  + The parent as a shareholder cannot be pierced in most circumstances unless the parent is exercising control.
  + The subsidiary should observe its own formalities.

1. United States v. Bestfoods: (pollution piercing case)
2. Facts: bestfoods alleged it could not be held liable for the actions of a corporate subsidiary
3. Rule: A corporate parent that actively participated in, and exercised control over, the operations of a polluting facility itself, may without more, be held directly liable in its own right as an operator of a faclity.

* Corporate Formalities:
  + To protect against a veil piercing corporations should adhere to the relatively simple formalities of creating and maintaining a corporate entity.
* “Alter ego” liability- the individual shareholders may be liable if the corporation is merely an alter ego of the individual.
* Two Pronged Test:
  + Unity of interest:
    - Formal prong
    - Has the defendant observed the formalities of the corporation?
  + Fraud or equity:
    - More difficult to prove
    - Must prove that maintaining the corporate fiction would sanction fraud or promote injustice
* CA Uses a similar test:
  + Legal prong
    - If legal prong cannot be proven, the case is dismissed
  + Equitable prong
* The veil has not been pierced in public corporations.

1. Tort Claims

* The lack of a remedy is not enough to pierce the corporation.
* Voluntary contract creditors are more likely to prevail.
* Formalities demonstrate that the corporation is a separate entity.
* If the shareholders and corporation are considered “one” the shareholders and corporate assets can be exposed.
* A tort victim involuntarily becomes the corporation’s creditor.

1. Baatz v. Arrow Bar: (over serving tort piercing case)
2. Facts: The plaintiffs (crash victims) sought to hold bar owners (bar owners) personally liable for the alleged tort of their corproation
3. Rule: Controlling shareholders will not be liable for a corporation’s torts absent use of the corporation to effect a wrong.
4. Holding/Notes: A corporation’s shareholders, even controlling shareholders, will not be personally liable for corporate debts.

* The extent to which a corporation must be capitalized so as to not raise the specter of piercing the corporate veil varies greatly. The more risky the venture, the more it must be capitalized.

1. Walkovsky v. Carlton: (multiple cab tort cse)
2. Facts: Plaintiff was struck by a taxi cab owned by a corporation owned by a shareholder who owned ten other corporations of taxi cabs. Plaintiff sued the ten corporations
3. Rule: Whenever anyone uses control of a corporation to further his own rather than the corporation’s business, he will be liable for the corporation’s acts. Upon the principle of respondent superior, the liability extends to negligent acts as well as commercial dealings. However, where a corporation is a fragment of a larger corporation combine which actually conducts the business, a court will not pierce the corporate veil to hold individual shareholders liable.
4. Holding/Notes:
5. Contract Claims:

* For contract based claims, the analysis is usually under two prongs: (1) were the identities of the shareholder and the corporation so inseparabale that their separate legal existences could cease; and (2) would some inequitable result occur unless the corporation’s veil is pierced.
* The court will consider whether the contract creditor conducted a investigation into the credit of the corporation.

1. Sealand Services Inc. v. Pepper Source (pepper case)
2. Facts: Plaintiff could not collect a shipping bill because corporation had been dissolved.
3. Rule: The corporate veil will be pierced where there is a unity of interest and ownership between the corporation and an individual and where adherence to the fiction of a separate corporate existence would sanction a fraud or promote injustice.
4. Holding/Notes: The corporation must remain separate from the individual shareholders.
5. Dividends and Distributions:
6. Tests:

* tests for dividends and distributions were originally designed as creditor protection.
* Statutes allow for some dividends while providing some protection for creditors.
* To provide creditors with protection, corporation statutes restrict distributions of company profits to owners.
* Most statutes treat dividends and distributions similarly but they are different
* Tests:

1. Earned surplus test- dividends may be paid only from the company’s earned surplus (accumulated retained earnings)
2. Balance sheet based test- a company may pay dividends only if the assets exceed the sum of its liabilities and its stated capital.
3. Nimble dividends test- a company may pay dividends if it has current profits, even if it does not have earned surplus.
4. Net worth test- permits payment of dividends to the extent assets exceed liabilities.
   * + Net worth equals the total value of equity.
5. Insolvency test- a corporation may not pay a dividend if the corporation is insolvent at the time the dividend is declared or if the payment of the dividend would make the corporation insolvent.
   * + Insolvent- liabilities are greater than the assets
     + Insolvency in the equity sense- focuses on the inability of a corporation to pay its debts as they become due in the usual course of its business.

* CA- must pass an insolvency test- whether a company can pay the creditors as the amounts become due
  + CA has a variety of tests corporations can use
* MA uses the earned surplus test
* DE uses either the balance based sheet test or nimble dividends test
* Surplus:
  + Surplus- the excess of the net assets of the corporation over the amount determined to be capital
  + Net aseets- the amount one gets from subtracting all of the corporation’s liability from its assets
  + There are two kinds of surplus:
    - Stated capital is equal to the aggregate par value of outstanding shares of stock.
    - Capital surplus is the aount shareholders pay for their shares in excess of the aggregate par value
    - Earned surplus- comes from a corporation’s earnings.

1. Dividends:

* Dividends- periodic payments to shareholders and may be paid out from the corporate treasury.
* Represent a payment to the shareholders of a corporation’s profits
* Types of dividends:

1. Dividends in cash or property

* The board of directors declares dividends.

1. Distributions:

* Distributions are a return to the shareholders of a portion of their capital contributions
* The repurchasing of shares constitutes a distribution.
* Corporations have the right to repurchase previously issued shares of their own stock.
* Under DE and the MA, the provisions controlling the payment of dividends also apply to a corporation’s redemption (repurchase) of its own shares.
* Under DE law, a corporation may repurchase its own shares only out of a surplus.
* Treasury stock- repurchased stock that is not retired or cancelled and is to be reissued later.
* The MA has eliminated the concept of treasury shares.
* Share repurchase- the repurchasing of the corporation’s own shares.
* When a corporation buys back its own stock shares, it does not receive anything of value in the hands of the corporation.

1. Stock Dividends and Stock Splits:

* Stock dividends are dividends payable to a corporation’s shareholder’s in the corporation’s own stock rather than in cash or other property.
* Stock splits have much in common with stock dividends
* Neither a stock dividend or a stock split changes the proportion of a shareholder’s equity participation in the corporation.
* All that it accomplishes is cutting the corporate pie into smaller pieces.
* There are three reasons corporations issue stock dividends or do stock splits:
  + The most common reason is to force down the price of stock in a publicly held corporation that has risen too high.
  + Managers will issue small stock dividends not exceeding a few percent to shareholders to show the company is prospering and the management team is reinvesting profits back in the business.
  + May be necessary when a corporation is planning to sell its shares to the public for the first time.
* Publicly held companies issue stock dividends much more oftn than stock splits.

1. Limitations on Dividends and Distributions:

* Jurisdictions with legal capital requirements limit a corporation’s ability to declare and pay dividends or make distributions, including the repurchase of shares.
* DE requires the availability of earnings or surplus for dividend payment or distribution.
* Surplus can come in three ways
  + Capital surplus is the different between the price at which a corporation issues stock and the stock’s par value.
  + Reduction surplus is created when an amount is transferred from stated capital to surplus.
  + Revaluation surplus comes from the unrealized appreciation of the company’s fixed assets

1. Corporate Social Responsibility:

* Stakeholder- those that have an interest in the health of the corporation but are not shareholders.
  + Employees, inventors, community…
* The board has a duty to the shareholders (owners).
* Provided that the shareholders benefit in some way, directions can make decisions based on other considerations (stakeholders).
* CA: Current Statute: 309
  + –Director’s perform their duties: “in good faith, in a manner that such director believes to be in the *best interest of the corporation and its shareholders*…
  + CA rejected a statute that would have allowed corporations to consider stakeholder interests.
* Benefit Corporations in CA:
  + B Corporation- requires a benefit report to be filed to describe how it achieved its environmental or social goals. (more reporting)
  + Flexible Purpose Corporation- corporation defines its social benefit beyond maximizing shareholder value.
* A business corporation is organized and carried on primarily for the profit of the shareholders and the powers of the directors are employed for that end.
* Over half of the states have statutes that authorize directors to consider the interests of groups other than the shareholders in corporate decision making.
* The DE Supreme Court has indicated that directors may consider other constituencies in their decision-making so long as there is some rationally related benefit accruing to the stockholders.
* The ALI provides that a corporation may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business.
* The Sarbanes Oxley Act of 2002 directed the securities and exchange commission to promulgate rules requiring annual and quarterly report disclosure concerning whether the company has adopted a separate code of ethics for senior financial officers.
* The Sarbanes Oxley Act of 2002 enacted a wide variety of corporate governance reforms.
  + The entire board is deemed an audit committee.
  + Most companies will appoint a committee.
  + Penalties were enforced and executive compensation may be lowered.
  + Required codes of ethics.
* Private companies were not subject to Sarbanes Oxley.
* Lawyers, Auditors, and Whistlerbloers were given additional duties and requirements to report.
* The committee is directly responsible for appointing, paying, and supervising outside auditors.
* All committee members must be independent and not collect fees other than salary
* Committees must establish procedures to promote employees reporting of misconduct and protect whistle blowers.
* Committees must be empowered to retain independent counsel and other advisors.
* Company must provide sufficient funding to pay advisors.
* The committee must have one financial expert.
* Shlensky v. Wrigley:
  + Whether the Chicago cubs should have nights games.
  + Plaintiff argued that the team should play at night and it was a waste of opportunity for the cubs not to play at night.
  + The court states that this is a business decision and there is no fraud, illegality, or self-dealing.
  + The court refuses to interfere with a business decision.
  + Directors are not required to follow the crowd and do what everyone else is doing,
  + The court implies that stakeholder consideration is allowable.
  + Not pursuing an opportunity for culture, stakeholders, or others is a valid business judgment.
* Charitable gifts:
  + Used to be considered corporate waste.
  + Now, CG are considered a business judgment based on goodwill, etc.
  + Building good will is a benefit to the corporation and the BJR applies.
  + Actions that harm the shareholders could give rise to a cause of action.

1. Corporate Fiduciary Duties:
2. Definitions and General Principles:

* Fiduciary- a status that arises from one party entrusting the management of property to another with special expertise.
  + Arises in a variety of relationships.
  + One person in a position of lesser knowledge of capability, justifiably relies upon the good faith, confidence, and trust in another, whose expertise, aid or advice, is sought for some matter, typically with an trustment of valuable property.
  + In fiduciary duties, the law requires the finest loyalty and due care,
  + Examples: princpal-agent client-lawyer patient-doctor layperson-clergyperson heris-executor ward-guardian student- teacher
* Board members and officers are fiduciaries to the corporation.
* The corporation’s directors and officers are subject to two traditional fiduciary duties: the duty of care and the duty of loyalty.
* Corporate law: fiduciary duty is a legal device to control for:
  + mismanagement
  + unfair self-dealing
* Most states do not allow waivers of fiduciary duties
* In carrying out their general responsibilities, directors are subject to a general standard of conduct.
  + This standard is often described in negligence terms: what must ordinarily prudent directors do, and have the directors excessively neglected their obligations.
* Once directors actually make conscious business decisions, courts refer to the business judgments rule
* Fiduciary duties imposed by law are default rules intended to solve problems stemming from the separation of ownership from control.
  + Doctrines are derived from agency law, and the “entrustment” concepts from the agency relationship.
* Fiduciary duties developed from common law (agency principles)
* Fiduciary duties dealt with the problem of:
  + Malfeasance- actions of the director adverse to the corporation
  + Nonfeasance- failure to act by the director that caused harm
  + Sef-dealing

1. Duty of Care:

* Applies when there is no conflict of interest; directors have the presumption of the business judgment rule.
* There are several components
* Directors are expected to promote the corporate interest and protect shareholders.
* It is a negligence matter, and there must be a duty, breach, cauasation and damages.
  + In most corporate contexts, a gross negligence standard is used.
* There may be a sliding scale, depending on the circumstances.
* Directors Must:
  + Understand the business
  + Keep informed
  + Generally monitor, which includes attend meetings
  + Have some familiarity with the financial status of the buisness as reflected on the financial statements
  + Reasonable supervision
* Certain industries and positions require a higher duty of care.
* CA Section 309(a):
  + A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
* RMBCA:
  + The term “ordinary prudent person” is not used, but “person in a like position.”
    - Purpose- ensure directors are not too cautious and encourages risk taking.
  + RMBCA - directors must act: (a) in good faith, and (b) in a manner the director reasonably believes to be in the best interests of the corporation; (c) the board when becoming informed or overseeing - “shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.”
* Director Reliance:
  + Directors may rely on a duly authorized committeee of the board upon which the director does not serve
  + Directors may delegate functions to committees, other directors, officers, employees, experts or other persons.
  + a director shall be entitled to rely on information, opinions, reports or statements, [including financial data]…prepared or presented by… (1) …officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented. (2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence. (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.
* Relevant and timely information is essential for board’s suprvisory and monitoring role.
* The duty of care includes an attempt in good faith to assure that an information and reporting system which the board concludes is adequate exists.
* Directors may have a duty to inquire but only when the circumstances would alert a reasonable director or officer to the need therefore.
* NonFeasance/Monitoring Cases:
  + The Caremark/Francis Standard applies.
    - Duty of care/gross negligence standard
    - Standard- duty, breach, causation, damages
* Malfeasance- Decision Making Cases:
  + The business judgment rule applies as a presumption
  + If no exceptions apply, review ends there, and business judgment rule prevents a review of the substantive decisions of the board.

1. Francis v. United Jersey Bank ( board of director duties- unsupervised sons)
2. Facts: Plaintiff sought damages from director for the alleged negligent performance of director duties after the corporation went bankrupt from her sons’ misappropriation of funds.
3. Rule: Where insiders have misappropriated corporate funds that were held in an implied trust for third-parties, it is said that the director owes a fiduciary duty to the third parties, and consequently, if the director fails to make an effort to fulfill his responsibility as a director, he will be deemed to have breached his duty of care and thus will be held personally liable to the third parties for the misappropriated funds.
4. Holding/Notes: Directors can be held liable for nonfeasance.
5. In re Caremark International Inc. v. Derivative Litigation: (alleged director violation of law)
6. Facts: Shareholders brought a derivative action seeking to recover 250 million in losses from caremark’s directors incurred as a result of Caremark’s violation of federal law.
7. Rule: Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he is deemed as satisfying the duty of attention.
8. Holding/Notes: Compliance with the duty of care may never be judged with reference to the content of the board’s discretion leading to a corporate loss.

* Standard for monitoring corporation:
  + The corporation must have a system in place for information about the information of the activities to come to the board.
  + The information must be able to be projected to the board and officers.
  + No system would be the breach of the duty of care
  + The type of system is based on the board’s good faith judgment.
  + If the board has suspicion, the board must take action.
  + Absent suspicion, the board can have a general system
  + Absent cause for suspicion, there is no duty to operate a system to ferret out wrongdoing.
  + The information and reporting system must be adequately designed so appropriate information will come to the board in a timely manner.
  + If the board thinks there are violations, the board must take greater action
  + Board duty- francis actions are a starting point
    - Caremark adds- relevant to information
* Sarbanes-Oxley and the Duty of Care:
  + CEOs and CFOs must certify accuracy of financial statements and control were implemented to promote reliable reporting.
  + Penalty is certain
  + Auditors must report certain things.

1. Duty of Loyalty:

* In addition to the duty of care, directors and officers assume a duty of loyalty to the corporation.
* Concept- do not harm or steal from the company; do not personally profit from a transaction with the company
* Directors must exercise utmost care towards the corporation.
* Applies when managers engaged in interested transactions with the corporation
* The duty of loyalty requires the directors to exercise their powers in the interests of the corporation and not in the director’s own interest or in the interest of another person or organization.
* Directors should not use their corporate position to make a personal profit or gain for other personal advantage.
* When a directed is “interested” there is no business judgment rule protection AND the common law standard of entire fairness applies.
* The classic duty of loyalty case involves a director or officer that enters into a transaction with his or her corporation.
* If the directors are interested, no business judgment rule protection.
  + Burden of proof is on the directors.
  + Fairness and best interest are dependent on the circumstances.
* The traditional common law test is the burden of proof is on the directors to prove fairness.
* Under the majority view, if the directors can demonstrate the statutory requirements were met, the transaction enjoys a safe harbor from judicial review as to the claim concerning the interested person’s conflict of interest.
* Approached to Interested Director Transactions:
  + The disinterested director approval- interested directors are recused from the vote
    - This is a safe harbor
  + Another safe harbor is to get disinterested shareholder approval.
    - Called majority of the minority vote
  + Two basic insultating approaches: disinterested directors, disinterested shareholders

1. Lewis S.L. & E (landlord tenant waste case)
2. Facts: A shareholder claimed the directors had committeed waste of the corporation’s assets by undercharging a tenant.
3. Rule: The burden of proof rests on the interested director to show that the transaction was fair and reasonable to the corporation.
4. Notes:

* Court articles the common law rule: shareholders can void any transaction unless the transaction is shown to be fair and reasonable to the corporation.
* When the directors have a personal interest in the transaction, they are no longer immune from review and must demonstrate that the transaction was fair and reasonable
* If the transaction is fair, then there is no liability even if information was withheld from the stockholders or other directors.

1. Benihana of Tokyo v. Benihana Inc.
2. Facts: Plaintiff contends directors breached their fiduciary duties by authorizing issuance of preferred stock to raise capital where one of the board members negotiated a deal without the board’s knowledge.
3. Rules:
   1. Where a corporation’s certification of incorproation provides no stockholder shall have preemtive rights, but the board is authorized to issue preferred stock, the board is authorized to issue preferred stock with preemptive rights.
   2. An interested director does not breach his fiduciary duty of loyalty where the director neither sets the terms of the transaction nor deceives nor controls or dominates the disinterested directors approval of the transactions.
   3. A board validly exercises business judgment where it subjectively believes a transaction it is approving is in the company’s best interest and for a proper corporate purpose.

* Interested Director Transactions: Three Modes of Analysis:
  + Using statutory safe harbors does the follow:
    - Shifts burden of proof from diretors proving fairness to shareholder, subject to business judgment rule (benihana)
    - Shift burden to shareholders to prove unfairness (Lewis;Mariciano)
    - Transaction not void, but voidable and directors still have burden to prove fairness (a minority position)
* DE, CA, and RMBCA Approaches:
* DE (statutory approach)
  + A board committee in DE can consist of one director
  + DE carved out statutes if the director is interested.
  + These types of decisions are not protected by the business judgment rule nor are directors insulated from monetary damages.

1. Marciano v. Nakash: (jeans case)
2. Facts: A loan by board members was validated as a fair transaction.
3. Rule: A transaction by a corporation with its insiders will be valid if intrinsically fair.

* CA similar to DE
  + For shareholder vote- facts of diectors interest are to be fully disclosed and in a shareholder vote, the shares owned by the interested directors are not entitled to vote or
  + Disinterested directors must approve (and there must be a quorum)
  + For a director vote- if vote is by the whole board, disinterested directors still must be a majority of the quorum
  + CA requires two directors for a board committee
  + CA Burden of proof- allocates burden of proof to the challenger for transactions approved by disinterested voters
* RMBCA:
  + Does not follow common law development closely
  + Seeks to define conflicting interest transactions more carefully to exclude minor conflicts
  + sets forth procedures that insulate the transaction from fairness challenges, not just shift burden of proof
* Statutes:
* Satisfying the procedural rules will shift the burden of proof to the complaining shareholder to either (1) prove unfairness, or (2) overcome a re-established business judgment rule presumption; and
* If the shareholder meets this burden, the burden shifts back to the directors to prove substantive fairness.
* Alternatively, the directors can simply assume the burden of proving fairness without following the procedures to shift the burden of proof.

1. Business Judgment Rule:

* General Rule- when the board acts or chooses not to act, it will not be liable for poor business decisions.
* Protects managers from judicial scrutiny of their decisions. Does not apply if plaintiff demonstrates:
  + managers had a conflict of interest
  + managers were not informed
  + managers did not act in good faith
  + no rational business purpose- no win situation
  + transaction was unlawful
* The business judgment rule does not apply when the director acted in bad faith, had an interest adverse to the company, where the company’s action was illegal, where the company was in a no-win situation (no rational business purpose), and where the board failed to act on an informed basis.
* The business judgment rule is a presumption that the board’s process was loyal, informed, and intended to serve the corporation.
* If no business judgment rule protection, the decision is no longer protected from review.
  + Court may review the decision under either a duty of care or an “entire fairness” review
  + A breach of the duty of care may already be established, and only causation and damages need to be proven.
* The presumption of the business judgment rule can be undermined if the plaintiff can show the board entered into a no-win situation.
  + If there is no rational business purpose/decision- the board does not get protection.
    - The board then defends under a duty of care analysis.
  + A no-win situation is not protected by the business judgment rule.
* The business judgment rule is an alternative analysis to the general standard of care.
* Once directors make conscious corporate decisions, thereby exercising their business judgment, their conduct is generally subject to the business judgment rule.
* So long as the directors do not behave egregiously, the consequence of the business judgment rule is to substantially lower the possibility that drectors will be found liable.
* Shareholders accept the risk that a sound business decision may not result in success.
* Rule applies when directors have made a conscious decision and not when they have been inattentive
* Business judgment rule will not apply when the directors have an “interest” in the transaction (and thus a conflict) or if the directors action is illegal
* Some courts view it as a presumption that can be rebutted in certain linmited circumstances.
* The rule of conduct is the duty of care- to act in an informed, prudent manner, in good faith, with adequate information.
* The business judgment rule is a presumption that is rebuttable.
  + If rebutted, the directors must fall back on their defense under the grosss negligence duty of care.
  + rebutting the business judgment rule: How would it be rebutted: E.g. A showing that directors were interested in the transaction; a showing that the transaction was illegal; a showing that the directors acted in “bad faith”; a showing that directors acted without having adequate information; a showing that the transaction could never benefit the corporation. Plaintiff’s bear this initial burden of proof.
* The business judgment rule is focused on the process and not the substance of the director’s decisions.
  + If the process is unbiased and the directors were not interested in the subject matter, then liablity will not attach to their decision.
* Even if directors make a conscious decision, the business judgment rule may not be applicable. There are at least two exceptions:
  + Directors and officers who are interested in the corporate decision may be subject to a different standard of conduct (duty of loyalty)
  + If the director’s decision itself constitutes illegal conduct, directors will not be protected.
* The business judgment rule acts as a safe harbor but it is not the rule of conduct, which remains the duty of care.
* Van Gorkam Notes:
  + The pivotal issue was whether the directors were informed.
  + The board must be informed and act on an informed basis.
  + Van Gorkam focuses on the process rather than the substance.
  + Heightened the requirements for the business judgment rule.
  + A presumption for the protection of the business judgment rule was that the directors acted on an an informed basis.
    - If the board is not informed, there is no presumption of the business judgment rule.
    - Court ruled no business judgment rule protection and therefore directors breached their duty of care.
    - The board made no inquiry on the price. Board did not understand the agreement. Board based some decisions on a “market test” but it was not assured.
    - Some scholars believed the case was wrongly decided because of the premium of the market price.
    - Boards were more likely post Van Gorkam to hire bankers for fairness opinions.
  + Legislative Responses to Van Gorkam:
    - States passed immunizing statutes to limit director’s liability for monetary damages or lower the standard of conduct required for a director.
      * In response the DE General assembly amended the DE Corporate Code to allow corporations to adopt charter provisions eliminating or limiting the personal liability of directors for breaches of the duty of care.
      * DE- limiting/eliminating liability
      * Lowering standard of conduct- instead of reasonably prudent director to good faith business judgment.
    - After Van Gorkam, many jurisdictions enacted statutes to decrease directr liability risks. Three types of statutes emerged:
      * First as illustared by DE’s general corporation law- some statutes allow individual corporations, typically through shareholder action, to include in their articles a provision limiting or eliminating director’s liability.
      * Second as illustrated by VA’s code, some laws alter the standards of fiduciary duties imposed on all corporate directors, typically by lowering the standard of conduct.
      * Third, ALI, allows shareholders to limit the amount of director’s liability.

1. Joy v. North: (business judgment rule)
2. Rule: A corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes, or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation.
3. Notes: The business judgment applies only when the corporate decision has a valid business purpose.
4. Smith v. Van Gorkom ( stock price case- really important)
5. Facts: Complicated set of facts where directors approved a merger without reading the proposal because the stock price was great.
6. Rule: Directors are bound to exercise good faith informed judgment in making decisions on behalf of the corporation.

d. Good Faith v. Bad Faith:

* The duty of good faith is likely an element of the duty of care and the duty of loyalty and not an independent duty.
* Bad faith cuts through the business judgment rule.
* (Disney)A conscious and intentional disregard of responsibilities, adopting a “we don’t care about the risk” attitude or an intentional dereliction of duty a conscious disregard for one’s responsibilities.
  + “intentional dereliction of duty; conscious disregard for one’s responsibilities/deliberate indifference and action in the face of a duty to act.
* (Stone v. Ritter) “A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.”
  + There is an intent element.
* Waste:
  + A transaction so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.
  + Equivalent to the rational business purpose prong of the business judgment rule.
* Compensation Agreements:
  + Usually a matter of business judgment on receipt of adequate compensation.
  + To attack compensation agreements, plaintiffs usually have a heavy burden to prove inadequate consideration to the corporation.
  + When directors have a personal interest in the compensation decision, directors are under a duty of loyalty and bear the burden to prove adequate compensation.
  + For board compensation, there are no disinterested board members, but compensation to the board for board duties is very modest, and is rarely challenged on fairness grounds.
  + Officer compensation has traditionally been a duty of care matter, and usually decided by a disinterested board committee (like Disney).
  + Standards in these instances are duty of care and the business judgment rule, unless the directors are interested.
  + ALI general rule- a director or senior executive who receives compensation from the corporation for services in that capacity fulfills the duty of fair dealing with respect to the compensation if either:
    - The compensation is fair to the corporation when approved
    - The compensation is authorized in advance by disinterested directors or authorized by a disinterested superior
    - The compensation is ratified by disinterested directors who satisfy the requirements of the business judgment rule
    - The compensation is authorized in advance or ratified by disinterested shareholders and does not constitute waste

1. In re The Walt Disney Company: (employment agreement/good faith)
2. Facts: Shareholders alleged disney’s director’s violated the duty of due care and good faith which contained a no-fault termination that could result in an enormous payout.
3. Rules:
   1. Due care and bad faith may be treated as separate grounds for denying business judgment rule review.
   2. An entire board does not have to consider and approve an employment agreement.
   3. A due care analysis does not have to be made on a board directly.
   4. Members of a compensation committee do not breach their duty of due care although they may not follow the best pactices, make an informed decision.
   5. Intentional dereliction of duty, a conscious disregard for one’s responsibilities is an appropriate legal definition for bad faith.
   6. An entire board does not breach by having the CEO terminate
   7. A director does not breach th duty of care or the duty to act in good faith by making a decision based in fact and that is made within business judgment.
   8. When directors rely on accurate information and their reliance is in good faith, there is no breach of duties.
   9. Where payment constitutes a rationale business purpose, there is no waste.
4. Notes:

* If bad faith is estalished, there is no business judgment rule protection.
* Plaintiff must meet the burden to plead at least a prima facie case of bad faith to overcome the business judgment rule.

1. Stone v. Ritter: (banking regulations case)
2. Facts: Shareholders alleged violations of fiduciary duties when a bank failed to comply with regulations.
3. Rule: An action for breach of director’s oversight duty will be dismissed where alleged particularized facts do not create a reasonable doubt that the directors acted in good faith in exercising oversight responsibilities.
4. Holdings/Rule: the failure to act in good faith is a condition to a breach of the duty of loyalty. A failure to act in good faith gives rise to liability only indirectly.

* The court found in this case that monitoring was an issue of good faith and good faith was an element of the duty of loyalty.
* If good faith concerns loyalty the duty of loyalty is widened to be more than just about financial or other conflicts of interest.

1. Arnold v. Society for Savings Bancorp, Inc. (corporation sued in a merger)
2. Facts: Shareholders sued corporation for a merger for failure to disclose material facts in a merger proxy statement.
3. Rule: A court will not go beyond the express, unambiguous language of the relevant statute in construing a statutory provision in the certificate of incorporation shielding corporate directors from liability for breach of fiduciary duty.

* Court states it doesn’t matter if there was a misstatement because directors would be shielded from liability because of the statute from monetary damages.
* Just because the actor was an officer and director, the actions taken were that of a director, so he was protected by the statute.

1. Malpiede v. Towson (Fredericks of hollywood case)
2. Facts: Shareholders sued over a merger dispute.
3. Rule: A breach of the duty of care claim must be dismissed when a corporation has an exculpatory provision in its charter that precludes money damages for director’s breach of the duty of care.

* For a plaintiff to get over their initial burden- and survive summary judgment- plaintiff must have well-pleaded facts to show bad faith or burden of duty of loyalty
  + Shareholders can get facts through their inspection rights.

1. WLR Foods, Inc. v. Tyson Foods, Inc.
2. Rule: Directors actions in Virginia are not to be judged for their reasonableness.
3. Notes:

* Bad faith- avoiding requirements of shareholder approved plan- equals disloyalty

1. Ryan v. Gifford (backdating options case)
2. Facts: Shareholder alleged directors and board compensation committee breached duties of loyalty and care by approving and backdating options.
3. Rule: A complaint that alleges the deliberate violation of a shareholder approved stock option plan, coupled with fraudulent disclosures, sufficiently alleges bad faith to rebut the business judgment rule presumption and survive dismissal.
4. Notes:

* The court finds plaintiff’s argument that a purposeful/intentional failure to honor the provisions of a shareholder approved stock option plan was sufficient to rebut the business judgment rule on bad faith grounds and finds breach of duty of loyalty.

1. Corporate Opportunity Doctrine: (Duty of Loyalty)
2. Corporate Opportunity Doctrine:

* The corporate opportunity doctrine is part of the duty of loyalty.
* The corporate opportunity doctrine can apply to any opportunity that the corporation and the fiduciaries both claims as theirs.
* Most disputes arise when the fiduciaries are in competition with the corporation.
  + Example- fiduciaries starting a business that directly competes with the corporation.
* The corporation does not want the fiduciary to use the corporation’s resources and assets to pursue individual goals.
* Society does want to encourage individuals to pursue opportunities that lead to creation of new businesses.
* The incentives influence policy: strong bar to taking opportunities would discourage board membership
  + Weak bar would lesson ability of corporation to benefit from director’s knowledge.
* A director of a target company can take opportunities of an acquiror, provided they are not also opportunities of the target company.
  + A director does not have to be concerned with the aquiror’s goals/concerns
* DE (Guth) Standard: Consider whether:
  + The corporation is able to take the opportunity
    - This examines the finances.
  + The opportunity is in the corporation’s line of business
  + Corporation has an interest or expectancy in the opportunity
  + Fiduciary has interests against the corporation
    - Presenting the opportunity to the board and having the board reject is a safe harbor.
    - Guth is a balancing test; no one factor is dispositive
    - “Expectancy:”
      * Some connection between the property and the nature of the corporate business.
* ALI Test:
  + A director may take advantage of a corporate opportunity only after meeting the strict requirement of full disclosure.
* Three popular approaches include:
  + Does the corporation have a protectable expectancy to the opportunity?
    - Would the fiduciary and corporation reasonably expect that the opportunity belongs to the corporation
    - Is it fair to the corporation for the fiduciary to take the opportunity? A farness analysis may include:
    - Whether the opportunity was of special value
    - Whether the corporation was actively negotiating for the opportunity and
    - Whether the corporation was in a financial position to pursue the opportunity
    - Whether the fiduciary received the opportunity because of their corporation position
    - Whether the fiduciary used corporate resources
    - Whether the fiduciary intended to resell the opportunity to the corporation
    - Analysis of “fair,” good faith unfar bargaining and whether the fiduciaries would be in an adverse and hostile position
  + Did the corporation have the actual capacity to develop the opportunity?
    - The court considers all aspects of capacity- legal, contractual, statutory, organizational,
    - The courts tend to focus on the financial resources.

1. Broz v. Cellular Information Systems inc (aquiror duties)
2. Facts: Defendant utilized a business opportunity for his wholly owned corporation instead of aquiring company for which he served as a member of the board of directors.
3. Rule: The corporate opportunity doctrine is implicated only in cases where the fiduciary’s seizure of an opportunity results in a conflict between the fiduciary’s duties to the corporation and the self-interest of the director as actualized by the exploitation of the opportunity.
4. Notes: The court will consider whether the corporation had the financial ability to pursue the opportunity.
5. Northeast Harbor Golf Club, Inc. v. Harris (golf course land case)
6. Facts: Defendant personally bought and developed adjoining property without advising board members.
7. Rule: Corporate officers and directors must disclose all relevant information prior to taking personal advantage of any potential corporate opportunity.
8. Notes: Good faith can be considered by the court. The duty of loyalty can be discharged in good faith.
9. Securities Laws:
10. History:

* 1911- first regulation of the issuance of securities.
* Until 1929, securities laws had limited jurisdiction, special interest exemptions, and state resources limited enforcement

1. Securities Laws Today:

* Securities can trouble attorneys because the there are many opportunities for error and easy to mistake what is a security.
* There are two regimes for every securities transactions:
  + State regulation:
    - Merit review based: states review the merits of transactions
    - Meaning a substantive review of whether the security is suitable for the citizens
  + Federal Regulation:
    - Disclosure based
    - Meaning was the required disclosure given.

1. Federal Securities Laws:

* Federal Exemptions:
  + Section 4(2)- provisons do not apply to transactions by an issuer not involving any public offering.
  + Regulation D- a safe harbor under 4(2)- what does not involving a “public offering” mean.
  + Limited Federal Preemption- National Securities Market Improvement Act

1. Securities Act of 1933:

* Concerned with offers and sales of securities (regulation of issuances of securtirs by issuers
* Every offer (a sale is something else) of a security requires a regustration statement be on file with the SEC except:
  + When there is an available exemption from registration
  + Burden of proof to establish the exemption is on the person claiming it.
  + BOTH a federal and state exemption is required.
  + One cannot make a sale of any security without the registration statement (filed with the SEC in order to make offers) being declared effecive by the SEC except:
    - when there is an available exemption- burden of proof is on person claiming exemption
* The 33 act goversn the process of going public.
* Section 5 Mandates:
  + No offers until a registration statement is on file
  + Offer may only be made by a prospectus
  + Sales may only be made when registration statement is declared effective by the SEC

1. Exchange Act of 1934:

* Regulation of trading and trading markets and periodic disclosure of companies that have already issued securities.
* This act established the SEC
* 34 Act regulates markets including:
  + Exchanges
  + Trading issues
  + Shareholder communications
  + Tender offers and ownership disclosures.

1. Federal Securities Liability Regime:

* Liability Rules make fraud easier to prove than common law fraud.
* 33 Act:
  + Registration statement liability
  + liability for failure to register securities
  + liability for misstatements
* 34 Act:
  + Section 10(b) and 10(b)(5)- anti-fraud provisions- general anti-fraud statute and rule.

iv. Sarbanes-Oxley:

* Major encroachment on state corporate law
* Imposes uniform requirements on all public companies.
* Takes away from board determining what is in best interest of corporation for these matters.
* Williams Act- brought federal security regulations to tender offers.

1. Securities Exchanges Act Rules:

* Rule 14(d)- Equal treatment security holders. All holders rule.
  + No bidder shall make a tender offer unless the tender offer is open to all security holders of the same class.
  + Best price rule- the consideration paid to the holders is the highest consideration paid to any other security holder during such tender offer.

1. Corporate Combinations and Tender Offers:
2. Corporate Combinations:

* From the seller, the transaction could involve selling the corporation to the buyer of some or all of the corporation’s assets and liabilities ( called an asset transaction) or transfer some of the selling corporation’s shareholders to the buyer of some or all the selling shareholder’s stock.
* From the buyer, the transaction may involve the transfer by the buyer to the selling corporation or its shareholders of cash or shares of the buying corporation
* The four types of transactions are:
  + Cash for assets
  + Stock for assets transaction
  + A cash for stock transaction
  + Stock for stock transaction
* Some of these can be consummated through a merger- where corporations marry one another.
  + Not used when the buyer pays cash for stock to acquire the selling corporation’s assets or assume its liabilities.
* Business combinations are impacted by tax and securities laws.
* There is an issue of whether third parties must consent or approve the transaction.
  + Loan agreements, IP licenses, leases
* There are two corporate law factors:
  + Whether shareholders of the constituent corporation are etitled to vote to approve the transaction
  + Whether any shareholders dissenting from it are entitled to appraisal rights
    - State law statutes determine whether shareholders have voting or appraisal rights.
* Traditional statutes- like DE- require both shareholder bodies to vote in a standard statutory merger and offers both appraisal rights.
* Under DE law, in a standard acquisition, the shareholder have voting rights, but not appraisal rights.
  + MA- both voting and appraisal rights
* In an asset-liabilities sale, the shareholder shave voting rights but not appraisal rights

1. De Facto Mergers:

* Shareholder voting and appraisal rights depend on the type of transaction.
* De facto merger doctrine- if a transaction produces the effects of a statutory merger than the same voting and appraisal rights are required.

1. Hariton v. Arco Electrics, inc. (de facto merger case)
2. Facts: Arco sold all of its assets to Loral in exchnage for Loral common stock. Shareholder plaintiff in Arco challenged transactions as a de facto merger.
3. Rule: A corporation may sell its assets to another corporation even f the result i the same as a merger, without folloiwng the statutory merger requirements.
4. Notes: This is the minority rule. Focuses on the form rather than the substance

* Independent legal significance- each form is legally significant and will be evaluated independently.

1. Farris v. Glen Alden Corp:
2. Facts: Glen Allen and List entered into a reorganization agreement under which Gln was to acquire List’s assets.
3. Rule: A transaction which is in the form of a sale of corporate assets but which is in effect a de facto merger of two corporations, must meet the statutory merger requirements in order to protect the rights of the minority shareholders.
4. Notes: substance over form- if the deal is a merger in disguise, it will be deemed a merger and shareholders will get dissenters rights
5. Successor Liability:

* Ray v. Alad: CA case- purchase of assets transaction:
  + Usually insulates buyer from liabilities of seller, except when liabilities assumed or certain narrow circumstances are present.
  + Policy of protecting injured users of defective products
  + Can be an issue for pharmaceutical companies.
  + CA- if you are purchasing a product line of a comapny the buyer will be liable for personal injuries under a theory of successor liability.

1. Knapp v. North American Rockwell Cop. (pie case)
2. Facts: MSJ granted to defendant on ground that one injured by defective machine may not recover from the corporation that purchased substantially all of the assets from the manufacturer of the machine because the transaction was a sale of assets.
3. Rule: A mere sale of corporate property by one company to another does not make the purchaser liable for the liabilities of the seller not assumed by it.
4. Notes: Liability may be imposed when the transaction is a consolidation or merger.

* Consider whether the parties can spread the loss.
* When substantial assets are purchased, the injuries from the equipment sold and injury claims can be brought against the successor.

1. Corporate Combinations Exceptions:

* Many state corporation laws provide exceptions to the usual requirements of shareholder approval and appraisal rights for business combinations.
* If the surviving corporation already owns at least 90% of the other corporation no shareholder vote on either side is required.
* If the surviving corporation does not issue its stock in the merger that increases its outstanding shares by more than 20%, no shareholder vote is required.
* Market out doctrine- based on the idea that shareholders dispense appraisal rights for public company shareholders receiving either cash or publicly traded shares in a merger.
* Triangular merge- referring to the presence of three corporate parties to a merger.
  + The parent creates a subsidiary which mergers with the other corporation.
* Share exchange- buying corporation issues shares to the selling corporation in exchange for the latter’s shares.
  + After the buying corporation owns the selling corporation as a subsidiary

1. Acquisitions:
2. Introduction and Background:

* Acquisitions bring up duty of care and loyalty issues.
* Allowing the market to control allows: assets put to highest valued use; valued delivered to shareholder; value/harm to stakeholders.

1. Acquisition Types:

* Some transactions have elements of all three.

1. Purchase of assets:

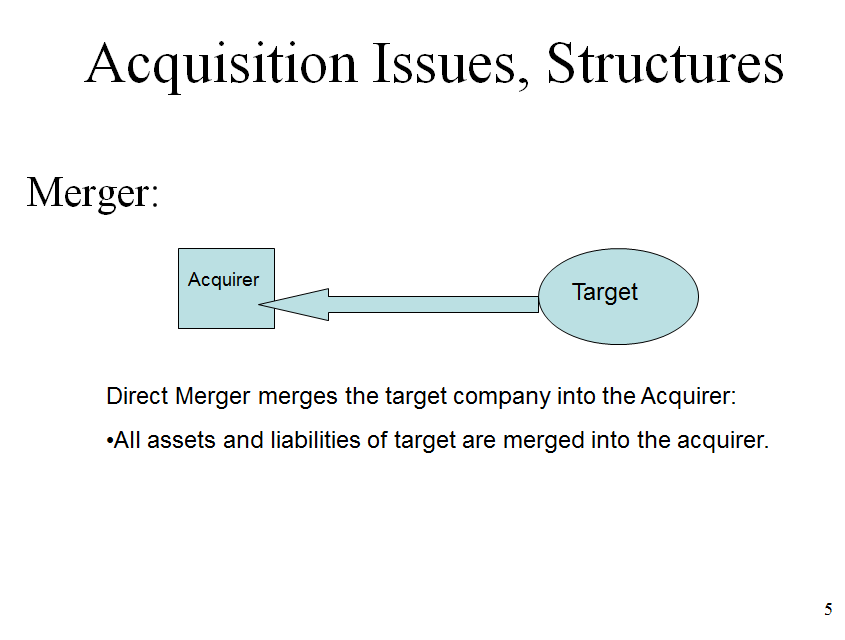
* Principle question for buyers: which assets to buy and which employees to hire.

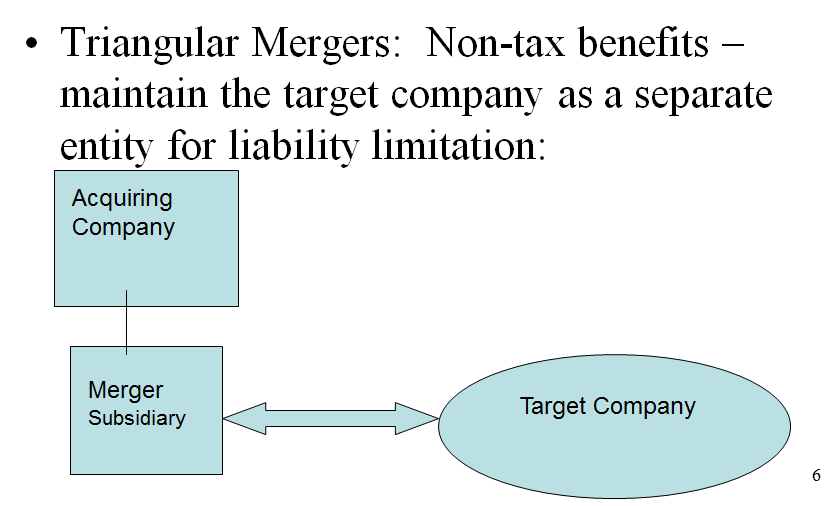
1. Purchase of Stock:

* Due diligence is critical because buyer gets assets and liabilities.

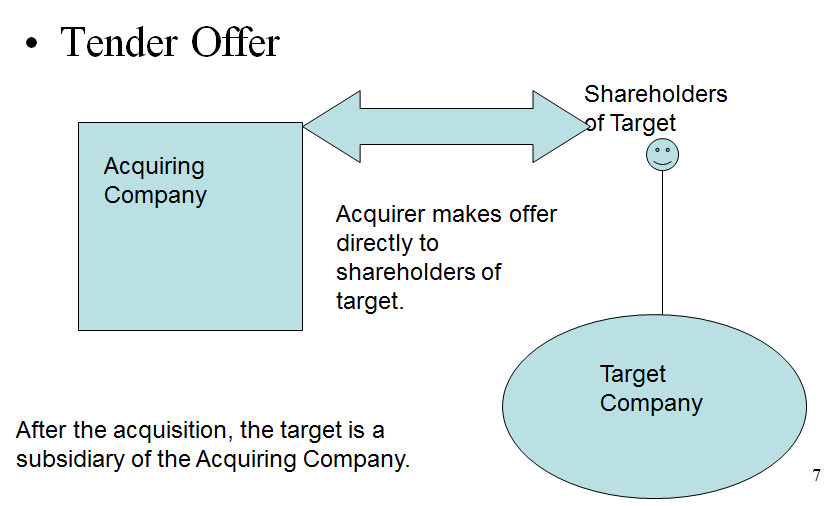
1. Merger:

* Done under state corporate law.
* Issues of due diligence and proper corporate approvals dissenters rights usually apply.
* To effect a merger:
  + Board approval of the target and acquirer
  + Shareholder approval of both entities.
    - Shareholders who don’t want to merge cannot stop the merger.

1. Acquisition Structures:
2. Merger: 
3. Triangular Mergers: The subsidiary isolates liabilities which will not affect the acquirer.

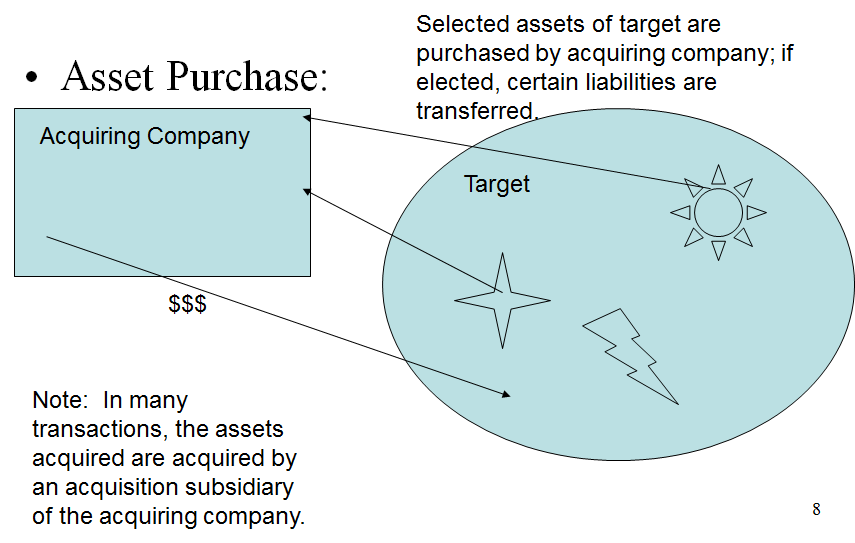


1. Tender Offers: Bypasses target baord and attacks the shareholders. After the acquisition, the target is a subsidiary of the acquirer.



1. Asset Purchase:

* Exchange of assets for stock or money.
* Acquirer may also assume debt or liabilities.
* In many states, dissenters rights do not apply.
  + Not considered a corporate transaction.



1. Takeovers:

* Mid 80’s high yield junk bond market developed under Drexel and Milken.
* With highly confident letters, bidders could make offers to acquire companies.
* Recent history:
  + Rise of activist shareholders:
    - Might promote a takeover
    - Might just change board with proxy
    - Might just influence the board to enhance shareholder value

1. Tender Offers:

* Tender offer- the acquiring corporation purchases directly from the shareholders of the target corporations a controlling interest in the company’s stock.
  + A general publicized bid to purchase shares of a publicly owned corporation.
  + Goal of regulation is to protect shareholders from responding without adequate information.
* A tender offer is an offer to purchase a majority (or some higher percentage of a target company’s stock.
  + If the offer is made without approval of target’s management, the offer is termed a hostile tender.
* The tender offer is made directly to the target corporation’s shareholders whether or not the target board approves.
* Target holders vote in the market by selling or refusing to sell their shares.
* The target corporation’s directors must do more than satisfy the ordinary business judgment standard of review.
* Private purchase public purchase dstinction- private sellers are less likely to be pressured.
* Second circuit prefers a two part test: look at the statutory purpose: do the persons sellinf ned the protection of the rule or can they fend for themselves (sophistication) AND
  + Is there a substantial risk that the solicitees lack information needed to evaluate the proposal.
* Regulation:
  + State law (clash/cooperation of shareholder and management)
  + Shares are freely tradeable, so power to tender or sell is with shareholders
  + Corporate managers can exercise their management powers

1. Hanson Trust PLC v. SCM Corp ( tender offers)
2. Facts: SCM obtained an injunction preventing Hanson from acquiing anymoe shares of SCM and from exrcising any voting rights as to the shares Hanson had already acquired.
3. Rule: The question of whether a solicitation constitutes a tender offer within the meaning of section 14(d) of the Williams Act turns on whether, viewing the transaction in the light of the totality of the circumstances, there appears a liklihood that unless the pre-acquisition filing structures of the statutes are followed there will be substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal put before them.
4. Steps in a Tender Offer:
5. Bidder buys an initial stake:

* If less than 5%, no disclosure required (note “group” rule)
* If more than 5%- disclosure of ownership required under Williams Act
* Purpose:
  + Lowers average cost of purchase
  + Provides upside of competing if competing bidder emerges.

1. Bidder Places newspaper advertisement to buy more shares at a premium prive, contingent on enough shares tendered to give bidder control.

* Shareholders can:
  + Do nothing
  + Sell stock in open market
  + Tender stock to bidder

1. Final Stages:

* Bidder usues control to merge target company with bidder’s acquisition company
* Merger known as a squeeze out merger
* Result: minority shareholders forced to exchnagfe their shares for the merger consideration (with available dissenters or appraisal rights)

1. Federal Law on tender Offers:

* Rule 14(d)-10 overrules the delaware court’s acceptance of discriminatory self-tenders

1. Duties of Board in Takeovers:

* Negotiated agreements for cororate control transactions often include provisions designed to protect the transaction against upset by competing bidders.
* Deal protection measures includes covenants that the target’s board will use best efforts to obtain shareholder approval or at least to recommend to shareholder approval.
* Revlon Duties:
  + When sale is inevitable, board has duty to maximize value for shareholders. Board needs to promote rather than chill the auction.
  + Difficult to determine when duties shift from Unocal to Revlon.
  + Lock-ups promote actions by drawing in bidders, but there are potential costs of a foregone auction.
  + The board must promote rather than chill an auction.
  + Whn the target company is in an inevitable sale, the board has a duty to auction the company.
  + Can consider other constituencies provided there is a rational benefit to the stock holders.
* When a company is in a take-over position, the directors can take a position of entrenchment.
* Before the business judgment rule will be applied, the court artiulates a two-part test:
  + Is there a threat that is made to the corporation that the threatens the enterprise, structure, etc?
    - Is there a threat that can be articulated?
  + Was the director’s response reasonable in relation to the threat posed?
    - The defensive measure taken must be in proportion to the threat.
    - The company cannot eliminate the possibility of the company being sold altogether.
  + Board gets business judgment rule protection if the two-part test is satisfied.
* Poison Pills:
* AKA Shareholders Rights Plan
* The most significant defense because of its ability to thwart an unfriendly takeover and give control to the target directors.
* In general, at some triggering event (usually the announcement or threat of a tender) the target issues to its shareholders RIGHTS.
* The RIGHTS are not immediately effective and can be redeemed by the target board but only after a subsequent triggering event (such as the purchase of a certain percentage of the target’s shares). The RGHTS then become non-redeemable and effective.
* The RIGHTS then allow the shareholders to obtain securities at a substantial discount. The discounted securities can be from the bidder ( a flip over plan) or from the target (a flip-in plan).
* The issuance of the securities pursuant to the RIGHTS have the effect of making the hostile tender offer more expensive for the bidder by either adversely affecting the target (a flip over plan) or the bidder itself ( a flip in plan).
* Boards cannot perform discriminatory self-tenders.
  + Offerors can still make tiered offers but everyone who accepts will be determined pro-rata.

1. Unocal Corp v. Mesa Petroleum Company:
2. Facts: Plaintiff (shareholder) was attempting a takeover that Unocal tried to fight off by making an exchange offer from which plaintiff was excluded.
3. Rule: Unless it is shown by a preponderance of the evidence that the director’s decision in fighting a takeover by one of the shareholders in the corporation was primarily based on perpetuating themselves in office, or some other breach of fiduciary duty, a court will not substitute its judgment for that of the board.
4. Note: The board can protect other constituencies.

* If the two part-test is satisfied, the business judgment rule will apply
* Unocal applies for defensive tactics of a corporation.

1. Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.
2. Facts: Plaintiff sought a preliminary injuntion and challenged the validity of certian actions taken by directors of Revlon in the face of what they considered to be a hostile takeover.
3. Rule: While directors may have regard for various constituencies in discharging their responsibilities vis-a-vis an attempted takeover, there must be rationally related benefits accruing to stockholders and, once the corporation dissolution becomes inevitable, the directors must allow market forces to operate freely to bring the shareholders of the target corporation the best price available for their equity.
4. Notes:

* If the corporation is going to be taken over, the directors must allow market forces to decide on who will get the corporation.

1. Good Faith in Takeovers:

* Lyondell:
  + DE SC found any breach of the duty of care would be exculpated under 102(b)(7) so the only issue remaining is whether the directors breached their duty of loyalty by failing to act in good faith.
    - Trial court incorrectly imposed Revlon duties before the board had decided to sell.
  + Revlon duties arise when the company embarks on a transaction (or forced into it) that will result in a change of control.
  + Revlon duties cannot be imposed before the board decides to sell.
  + There is one REVLON duty- get the best price for the stockholders at the sale.
    - The auction is no longer required.
    - Duty of care- did the directors take actions in their reasonable business judgments to maximize the price
    - Duty of loyalty- did the directors, knowing their duty, consciously avoid this duty, did the intentionally fail to act when they knew they should have acted.
    - Lyondell shows how board duties can be both duty of care and duty of loyalty in certain situations.
  + Bad faith relates to a conscious disregard of the board’s duties .
  + The duty of care does not require a valiant effort, just being infomed and making an unconflicted business judgment.
  + To prove bad faith, one would have to prove a failure to make efforts at all; a failure to try.

1. Lyondell Chemical Co. v. Ryan
2. Facts: Shareholder of Lyondell brought a class action suit against directors claiming the sale of Lyondell to Basell was tainted by directors self-interest and the directors therefore, breached their fiduciary duties by not maximizing the sale price.
3. Rule: There are no legally prescribed steps that directors must follow to satisfy their REVLON duties to maximize price in a sale on control transaction, such that failure to take those steps during the sale of their company demonstrates a conscious disregard of their duties.
4. Notes: Directors are required to act reasonably but not perfectly
5. Deal Protection Measures:

* Deal protection covenants are generally accompanied by specific contractual provisions expressly authorizing boards to take actions the covenants prohibit, including terminating the agreement.
* Bidder does not want to be the stalking horse.
* Target can obtain extra payment for granting enhanced certainty to a bidder.
  + The board has discretion to determine when deal protection measures are appropriate.
* Force the vote provisions- refers to a transaction in which a board agrees with a counterparty to submit a merger to a shareholder vote even if the board withdraws its own support between so agreeing and the submission time.
* A force the vote provision in the merger agreement requires the board to submit the original agreement for a shareholder vote in any event

1. No shop- board will not actively solicit bidders
2. No talk- board will not talk with potential suitors.
3. Lock-up- grant bidder to buy selected assets or shares.
4. Stockholder voting agreements- require major stockholders to agree to vote for the transaction to assure sufficient shareholders in advance.
5. Termination fees- payments if the transaction terminates by another buyer or by the shareholders voting down the transaction.
6. Omnicare, Inc. NCS Healthcare, Inc

a. Rule: Lockup deal protection devices, that when operating in concert are coercive and preclusive, are invalid and unenforceable in the absence of a fiduciary out clause.

* Adopting defensive devices to lock up the deal mandated special scrutiny under Unocal (765)
* There is an enhanced scrutiny of defensive devices and court must determine if those devices are not preclusive or coercive before determing whether those devices were within the range of reasonableness.
* Called “special scrutiny”
* The court looks at the defensive measures at the threshold before affording BJR.
* Defensive measures cannot be preclusive or coercive:
  + Precluisve- do the measures preclude all other deals beisdes the deal of the target
  + Coercive- does the sahreholder vote actually matter
  + If the devices preclusive or coercive are they reasonable?
* Post Omnicare- DE amends its statute to permit force the vote provisions even if the board no longer recommends the transaction.
* MA provides a similar provision.
* CA rejected Omnicare:
  + Allows for exchanging certainties where a higher bidder cannot break up the deal.

1. Indemnification and Insurance:
2. Indemnification:

* Common law: employees have rights to indemnification for certain expenses and losses in carrying out their employment
  + Caliifornia Labor Law 2802
  + Directors are not employees
    - Officers are employees
* What are the risks directors and officers face:
  + Legal expenses
  + Investigation costs
  + Expert witness expenses
  + settlement costs
  + Judgment or awards
* Expected costs equal the costs that can be incurred multipled by their liklihood of occurring.
* The most likely plaintiff group against a director or officer are the shareholders.
* The corporation can alter the personal liability of directors and officers in three ways:
  + Immunization statutes- DE-102(b)(7)- The corporation can utilize exculpation statutes- articles of corporation can diminish or eliminate director’s liability
  + Indemnification- The corporation may advance to or reimburse directors for their liabilities they incur as a result of their corporate decisionmaking
  + Insurance- The corporation can purchase insurance to cover the cost of director’s and officers liabilities.
    - Policies may provide for repayment to the corporation for its indemnification of director’s liabilities.
* Corporate agreements may provide for indemnification but receiving those payments may be a problem.
* The issue that must be addressed in indemnification statutes is the establishment of policies consistent with the broad principle: to ensure that indemnification is permitted only where it will further sound corporate policies and to prohibit indemnification where it might protect or encourage wrongful or improper conduct.
* Indemnification and insurance ensures individuals will serve as directors
  + Should deter meritless claims.
* Indemnification Statutes:
  + Because common law was unclear on director indemnification, the subject was taken over by statutes.
  + Corporate statutes provide for mandatory and permissive indemnification.
* Mandatory Indemnification:
  + –“a corporation *shall* indemnify a director who was *wholly* successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he is or was a director of the corporation.” MBCA Section 8.52.
  + Because most D&O claims are settled, the question becomes whether the mandatory indemnification provision applies.
  + A settlement that is with prejudice and results in the dismissal of the case without any payment or assumption of liability may be considered a success within the maning of that provision.
  + Settlements that are without prejudice to a claimant’s right to assert further claims against an officer are not successes.
* Permissive Indemnification:
  + Permits certain additional indemnification. Permissive indemnification can cover directors in a wide range of situations.
  + Because most D&O claims are settled, the question becomes whether the mandatory indemnification provision applies.
  + A settlement that is with prejudice and results in the dismissal of the case without any payment or assumption of liability may be considered a success within the maning of that provision.
  + Settlements that are without prejudice to a claimant’s right to assert further claims against an officer are not successes.
* CA does not have the “otherwise” language of DE

1. Waltuch c. Conticommodity Services:
2. Facts: When corporation refused to indemnify plaintiff for legal fees resulting from litigation that arose out of former employment, plaintiff sued.
3. Rule: To the extent that a director, officer, employee, or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding, or in defense of any claim, issue or matter, he shall be indemnified against expenses (including attorneys fees) actually and reasonably incurred by him.
4. Heffernan v. Pacific Dunlop GNB
5. Rule: A corporation may indemnify any person who was or is a party to any suit by reason of the fact that he is or was a director.

* Corporate insiders may be eligible to receive indemnification from a corporation when defending against a third-party suit or suit brought on behalf of the corporation.

1. Insurance:

* Corporations can purchase insurance to cover liabilities that company may not have power to indemnify
* Limits: knowing violations of law; intentional harms to the corporation; significant personal benefits to which insured is not entitled.
* Insurance can be preferable to indemnification for matters like securities laws violations.
* D&O Insurance- insurance covering corporate directors and officers.
* The corporation may purchase insurance coverage under circumstances where the permissive indemnification statute would often prohibit indemnification- to cover the amounts paid in settlement or adverse judgments
* Corporations cannot purchase insurance for a knowing violation of a law.
* Coverage is limited to breach of duty, neglect, error, misstatement, misleading statements, ommissions or acts.
* Criminal acts or deliberate fraud are generally excluded but fraid arising out of recklessness is covered.
* The losses must be fortuitous and cannot be caused by the corporation.
* Usually the policy overs two instanaces:
  + The corporations responsibility to indemnify directors and officers
  + Covers losses incurred by the directors or officers which the corporation is not permitted or required to indemnify.

1. Shareholder Derivitative Litigation:
2. The Derivative Action:

* Action brought by shareholders on behalf of the corporation
* Wrong remedied is a wrong to the corporation
* Filed against an officer, director, controlling shareholder, or a third party, or both
* Allows a shareholder to step into the shoes of the corporation and seek a remedy for the corporation that an individual shareholder could not seek for himself.
* Distinguished from direct actions:
  + Direct actions can be brought when shareholder suffers injury separate and distinct from that suffered by other shareholders, or there is a special duty between wrongdoer and shareholder.
    - Actions to enforce contractual rights are right- rights to vote; compel dividends.
* Recovery belongs to the corporation
* Plaintiff’s attorney has greatest personal interest in the case.
* Courts generally allow direct suits in close corporations, even if the public corpation action would be derivative.
* Recovery in derivative actions goes to the corporations.
* Shareholders can initiate a derivative suit if they are dissatisfied with management decisions.
* Corporate law vests plenary power in the board of directors.

1. Fed. R. Civ. Pro 23.1: Derivative Actions by Shareholders:
   * The SB Act of 2002 forbids a cororation’s officers and directors to trade securities received by them as corporate employees when the corporation’s pension plan participants are legally restricted from trading.
   * Violations of this law call for th forfeiture of profits made to the company without regard to intent
2. Distinguishing Derivative Suits:

* A critical issue in shareholder litigation is whether a particular action is personal or derivative
* Personal direct actions are brought to enforce their own rights ore to remedy their own injuries.
* Derivative actions are brought be shareholders in the name of the corporation to enforce a right of the corporation or to remedy a corporate injury.
* Derivative actions are more complex procedurally and difficult to bring
* Plaintiff wants the action as direct and the corporation as derivative
* Courts are likely to categorize an action as direct when it seeks prospective or injunctive relief.
  + To determine whether an action is direct or derivative: the follows questions must be answered:
    - Who suffered the alleged harm- the corporation or the stockholders individually AND
    - Who would receive the benefit of any recovery or other remedy- the corporation or the stock holders individually.
* Procedural Matters:
  + Designed to ensure plaintiff acts in the interests of shareholders as a group.
  + Designed to minimze non-meritorious strike suits
  + Standing:
    - Must have been a shareholder at time of injury;
    - must allege with particularity actions plaintiff took to get board to act and reasons for failure (the “demand rule”)
    - Must represent the interests of the shareholders
    - Only court can dismiss or approve of settloement action
    - Posting security to cover defendant’s reasonable costs

1. Insider Trading:
   1. Statutory violation:

* Violation of Section 10(b) of the 34’ Act and Rule 10(b)(5)- a rule issued by the SEC to implement the law.
* Broad anti-fraud mandate
* Easier to prove securities fraud than common law fraud
  + Reliance is not needed to be proven.
  + Must prove that the market was sufficiently efficient
    - Must prove efficient markets- information in market is accurate
* The statute does not explicitly mention insider trading.
* See Class 28 Slides for Rule.

1. Theory of Insider Trading:

* Premised upon board/officer fiduciary duty not to trade with shareholders (to whom the fiduciary owes fiduciary duties) when board member/officer has superior information.
* The insider is a fiduciary to the shareholder; the insider thus takes an asset of the shareholder and uses it against the shareholder to the advantage of the insider. Violates common fiduciary concepts.
* The taking of the information alone is not a securities law violation.
* The trading of securities based on that activity is fraudulent activity.
  + 10(b)-5 requires that the fraud be in connection with the purchasing or selling of securities.
* Themes of Insider Trading:
  + Efficiency
  + Fairness
  + Administrability
* Two Theories of Insider Trading:

1. Classical Theory- insiders should not deal with their shareholder from a position of superior information (stems from duty of candor)

* Based on board and fiduciary duties; deals with a fiduciary who had material non-public information with their shareholders.
* Information must be material and non-public.
  + Material- whether a reasonable person would want to know before buying shares.
* Taking of information and disclosure of information is not enough for a violation.

1. Misappropriation Theory: some dutyto another party was breached in connection with the trading of securities. Relies on a breach of duty (but not necessarily a duty that relates to the securities markets or to shareholders)

* And the trading on the information may be only remotely related to the misappropriation.
* There was a duty that was breached.
* The breach was in connection with trading of securities.

1. Chiarella v. United States (criminal insider trading case)
2. Facts: Chiarlla settled civil case with the SEC. Printer was charged with insider trading
3. Rule: A purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has no obligation to discloare material information he has acquired and his failure to disclose such information does not, therefore, constitute a violation of section 10 of SEC Act of 1934.

* No liability to printshop worker because he did not owe the sahreholders a duty; he was not an insider.
* Introduces concept of insider v. outsider.
* Court did not address the misappropriation theory

1. Dirks v. Securities Exchange Commission
2. Facts: Dirks was investigating fraud but charged with insider trading.
3. Rule: A tippee will not be liable for disclosing nonpublic information received from an insider where the insider will not personally benefit from the disclosure so as not to be in breach of the insider’s fiduciary duty.

* Whether the insider’s tip constituted a breach of the insider’s breach of the fiduciary duty:
  + Whether the insider received a personal direct or indirect benefit.

1. O’Hagan v. United States
2. Facts: defendant purchased shares of pillsbury stock after learing about a deal from a fellow lawyer.
3. Rule: Criminal liability under section 10b may be predicated on the misappropriation theory.
4. Special Committees

* Formed by the board with independent directors
* Function is to make independent decisions.
* In most states Aurbach is the rule- if committees are independent, they have benefit of BJR
* DE requires a two step analysis:
  + Committee must establish good faith and independent basis for conclusions
  + Court will determine whether the case has value.
* The special litigation committee has become an obstacle to shareholders who wish to pursue deritivative suits.
* When the shareholders allege impropriety, the board often appoints a special litigation committee.
* The committee usually includes directors whose conduct is not in question, and they are asked whether the corporation should bring suit
* Board also determine whether the corporation should seek a dismissal of a shareholder suit.
* The ALI adopts a dual standard of review regarding the corporation’s motion requesting a dismissal of a deritivate suit which is dependent on the nature of the allegations.
  + Actions involving violations of the duty of care are subject to the business judgment rule standard of review
  + Actions involving more serious allegations- duty of loyalty-the court will consider whether the special litigation committee was adequately informed under the circumstances and reasonably determined that dismissal was in the best interest of the corporation based on he grounds that the court deems to warrant reliance.
* MA provides that the court will grant a motion for dismissal if it is based on a determination in good faith after conducting a reasonable inquiry upon which its conclusions that the suit s not in the best interest of the corporation.
* If the determination is made by independent and disinterested parties, the plaintiff has the burden of proof.
* If not, the burden of proof is on the corporation.

1. Zapata:
2. Rules: Where the making of a prior demand upon the directors of a corporation to sue is excused and a stockholder initiates a deriviative suit on behalf of the corporation, the board of directors or an independent committee appointed by the board can move to dismiss the derivative suit as detrimental to the corporation’s best interests, and the court should apply a two step test to the motion:
   1. has the corporation proved independence, good faith, and a reasonable investigation?
   2. does the court feel applying its own independent business judgment that the motion should be granted.
3. Notes:
4. Auerbach:
5. Rule: Although the substantive aspects of a decision to terminate a stockholders derivative action against corporate directors made by a committee of disinterested diretors are bayond judicial inquiry under the business judgment doctrine, the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of its investigative procedures.

K we\* Indicates mandatory

